

Borenstein: State should expand what it taxes

By Daniel Borenstein
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CALIFORNIANS PAY SALES tax on DVD rentals but not for admission to a movie theater. Gift-wrapping and tuxedo rentals are taxable, but laundry and dry-cleaning services are not. We pay sales tax on parts to repair our cars and computers, but not for the labor. Alterations to a new suit are usually taxed, but taking in the waistline of an old one is not.

The state's Byzantine sales tax system should face scrutiny as Gov. Arnold Schwarzenegger and legislators search for ways to close a \$27.8 billion budget gap over the next 19 months. But, so far, the governor is placing too much emphasis on raising the statewide rate, currently 7.25 cents on the dollar, rather than expanding what's taxed.

Everyone in Sacramento but the intransigent Republican members of the Senate and Assembly recognizes that there is no reasonable way out of the current budget shortfall that relies solely on cutting spending. Taxes must be raised.

To his credit, Schwarzenegger has put some constructive proposals on the table. He suggests raising roughly \$1.7 billion by taxing oil extracted in California, the only state in the nation without such an oil severance tax. He would also generate nearly \$900 million by raising the tax on alcoholic beverages, which hasn't been increased since 1991, by a nickel a drink.

In addition, Mac Taylor, the nonpartisan legislative

analyst, proposes increasing the annual vehicle license fee from 0.65 percent of a car's value to 1 percent to generate about \$1.3 billion. It was 2 percent when Schwarzenegger was elected and promptly cut it, with the Legislature's blessing.

Taylor also suggests a 5 percent surcharge on state income tax, generating about \$2.3 billion. And he would reduce some special income tax credits for dependents and seniors, generating about \$1.2 billion.

All good ideas. But if you add them all up, that's only \$7.4 billion. It's won't come close to closing even half the budget gap — assuming, perhaps unrealistically, that the other half will come from spending cuts.

Which brings us back to the big-ticket item: sales tax.

Schwarzenegger grabbed headlines by proposing to increase the statewide sales tax, already the biggest in the nation, another 1.5 cents on the dollar, to 8.75 cents. That would generate about \$10 billion over an 18-month period.

Economists will debate the negative effect on the overall economy but it's probably small.

The problem, says Christopher Thornberg of Beacon Economics, is that our current sales tax system relies heavily on consumer goods that are going to be hit hard by the recession. "The center of this downturn is going to be consumer spending," Thornberg says. "He (Schwarzenegger) is raising the rate on what is going to be a shrinking revenue base."

I talked with Thornberg, UC Davis Professor Steven M. Sheffrin, and Steven Levy, director of the Center for Continuing Study of the California Economy.

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They're all economists. They all agree that Schwarzenegger's proposed sales tax hike is too steep. Rather than increase it so much, state leaders should consider broadening the services taxed.

To be sure, Schwarzenegger proposes some expansion of taxable services to include appliance and furniture repair, vehicle repair, golf and veterinarian services. It's a start, but it's a rather unsystematic hodgepodge of additions to the list. Judy Chu, a former state Assembly member who now sits on the Board of Equalization, has made a more comprehensive proposal that lawmakers should give serious consideration.

As she points out, California's sales tax system was enacted in 1933 and has not been reformed since then. During that time, the state's economy has shifted away from manufacturing of tangible goods and toward a services base. In the early decades of the tax, about two-thirds of disposable income was spent on taxable sales. Today it's about 43 percent.

In other words, our sales tax system has not kept up with our economy. For example, we don't tax diaper service, used clothing alterations, dry-cleaning, health club dues, commercial linen supply, exterminators, telephone answering services, downloaded software, taxidermy, parking lot fees, amusement park admissions, tickets for sporting events or most repair labor. All of those categories are taxed in at least 20 other states.

Indeed, the Federation of Tax Administrators surveyed the 50 states last year to find out which of 168 different services were taxed. California taxed only 21 of those services, placing it 42nd on the list. Hawaii and New Mexico led the way, with 160 and 158 taxable services, respectively.

Chu estimates that if California were to expand its sales tax base to include services already taxed by a

large number of states, it could generate about \$2.7 billion annually. That's if the sales tax rate were left unchanged.

Thornberg and others suggest going further by placing a sales tax on professional services, as seven other states already do.

"Tax the accountants. Tax the lawyers and doctors. And the economists. I should be paying sales tax on what I'm charging," he says.

Many are certain to balk. Indeed, a tax that would add to the cost of health care should be avoided. But we should consider most other services. It's a discussion we can't afford to avoid.

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