Michigan League for Human Services

February 2010

From Poodle Cuts to Pedicures: Why We Need a Sales Tax on Services

High unemployment and the prolonged recession mean the needs of Michigan's families are growing just as the state has fewer resources to help them. It's apparent that a more balanced approach is needed when it comes to revenue. Michigan needs a better alternative to a cuts-only approach and temporary tax increases. One solution is to modernize Michigan's antiquated sales tax.

As consumer spending habits change, Michigan's sales tax has failed to keep pace. When Michigan implemented the sales tax in 1933, consumption of services represented a smaller share of personal spending. However, by 2007, spending on services (as opposed to goods) represented nearly 60 percent of personal consumption nationwide, according to the Institute on Taxation and Economic Policy. In addition, taxable sales as a percentage of personal income have declined from just over 50 percent in fiscal year 1978 to approximately 35 percent in fiscal year 2009.[1]

Due to this change in consumer spending, Michigan forgoes billions of dollars in revenue by taxing only 26 services out of a possible 168, as defined by the Federation of Tax Administrators. It is estimated that for fiscal year 2008, Michigan lost $201 million alone by not collecting sales tax on arts, entertainment, and recreation.[2]

Michigan's Sales Tax

Michigan's sales tax is a consumption-based tax that is levied on the gross price of a tangible personal item. The tax was adopted in 1933 at a rate of 3 percent and was not increased to 4 percent until 1960. In 1974, the state constitution was amended to eliminate the sales tax on food and prescription drugs. With the passage of Proposal A in 1994, Michigan's sales tax increased from 4 percent to 6 percent, with all of the 2 percentage point tax increase and 60 percent of the original 4 percent rate going to school funding.

Unlike 36 other states, Michigan does not levy a local sales tax. When compared with other states, Michigan's fiscal year 2007 effective state and local sales tax of 6 percent ranked 31st in the country in fiscal year 2007. In addition, for the same time period, Michigan's effective state and local sales tax as a percentage of personal income ranked 29th in the country.[3]

Sales Tax and State Revenue

When the sales tax was first implemented in 1933, it generated $31.4 million in fiscal year 1934, or approximately $483 million in 2008 dollars.[4] Since fiscal year 2005, the first fiscal year in which Proposal A was fully implemented, it has

[1] Bean, M.E. (2009, December). Michigan's revenue and budget shortfalls. In *Putting Michigan's fiscal house in order*. Presentation to the Michigan League for Human Services' Annual Meeting and Policy Forum, Lansing, MI.
[2] Mazerov, M. (2009). *Expanding sales taxation of services: Options and issues*. Retrieved from Center on Budget and Policy Priorities website: http://www.cbpp. org/files/8-10-09sfp.pdf
[3] Michigan Department of Treasury, Office of Revenue and Tax Analysis, Tax Analysis Division. (2009). *Michigan's sales and use taxes 2008*.Retrieved from http://www.michigan.gov/documents/treasury/Sales__Use_Tax_Report_December_2009_305451_7.pdf
[4] Citizens Research Council of Michigan. 2008. *Outline of the Michigan tax system.* Livonia, MI: Author.

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generated, on average, $6.1 billion a year. However, when adjusted for inflation (to 2008 dollars) sales tax revenue in Michigan has declined 11 percent between fiscal year 2000 and fiscal year 2008, meaning the gap in the portion of the budget that the sales tax is used to fund is getting larger each year.

In fiscal year 2008 the sales taxes generated approximately $6.8 billion, which represented 27 percent of total state tax revenue, and approximately 2 percent of personal income.[5] The majority of the sales tax in Michigan is used to fund public K-12 education. It is estimated that for fiscal year 2010, sales tax revenue will be distributed in the following manner:

- School Aid Fund: 72.7 percent;
- Revenue Sharing: 24.8 percent;
- Comprehensive Transportation Fund: 1.2 percent;
- General Fund: 1.2 percent; and
- Health Initiative: 1/10th of 1 percent.

It is projected that sales and use taxes will account for only 17.8 percent of Michigan's total revenue for fiscal year 2010, or approximately $5.9 billion. Those same taxes are expected to make up 12.5 percent of the state's General Fund, with the sales tax alone making up over one-third of the state's School Aid Fund.

Sales Tax and Services

Thirty-eight states and the District of Columbia tax more services than Michigan. As of 2007, Hawaii taxed the most services, taxing 160 out of a possible 168, while Oregon taxed no services. Even compared with other Midwestern states, Michigan taxes relatively few services. According to the Federation of Tax Administrators, Illinois taxes 17 services, slightly fewer than Michigan's 26, most of which are utilities, while Iowa taxes 94.[6]

	Number of Services Taxed
Illinois	17
Indiana	24
Michigan	**26**
Minnesota	66
Ohio	68
Wisconsin	76
Iowa	94

Source: Federation of Tax Administrators, 2007

Expanding the sales tax to include services has been a trend that has been gaining momentum across the country, even as the nation has been in the midst of an economic downturn. For example[7]:

- In 2009, Maine expanded the sales tax to include a range of maintenance and service transactions such as dry cleaning and car repair which are estimated to bring in $25.7 million in revenue;
- In 2006, New Jersey extended its sales tax to include a multitude of services, such as: landscaping services ($108.9 million), mini-storage facilities ($16.3 million), tanning, massage, and tattoo ($11.7 million), and investigation and security services ($57.3 million);
- In 2004, Arkansas expanded their sales tax to include numerous services, anticipating that it would increase fiscal year 2006 revenue by approximately 1 percent.

In the first seven months of 2009 alone, 12 states increased sales taxes through such means as administrative changes, raising rates, or expanding the tax base to include previously untaxed goods and services.[8]

[5] Michigan Department of Treasury, Office of Revenue and Tax Analysis, Tax Analysis Division. (2009). *Michigan's sales and use taxes 2008*.Retrieved from http://www.michigan.gov/documents/treasury/Sales__Use_Tax_Report_December_2009_305451_7.pdf

[6] Federation of Tax Administrators. (2008). *FTA survey of taxation-update*. Retrieved from http://www.taxadmin.org/fta/pub/services/btn/0708.html#table

[7] Mazerov, M. (2009). *Expanding sales taxation of services: Options and issues*. Retrieved from The Center on Budget and Policy Priorities website: http://www.cbpp.org/files/8-10-09sfp.pdf

[8] Johnson, N., Nicholas, A.C., & Pennington S. (2009). *Tax measures help balance state budgets: A common and reasonable response to shortfalls*. Retrieved from The Center on Budget and Policy Priorities website: http://www.cbpp.org/files/5-13-09sfp.pdf

Taxing Services as a Balanced Approach for Sustained Revenue Growth

As households spend less on tangible goods and more on services, expanding the number of taxable services would help mitigate the resulting loss of revenues and provide the basis for future growth. The Michigan Department of Treasury estimates that taxing all service transactions in Michigan at the current sales tax rate of 6 percent would yield over $10 billion annually. If all feasibly taxable services had been taxed in fiscal year 2007, sales tax revenue would have generated approximately $2.9 billion and accounted for 36 percent of all revenue.[9,10]

The following list, compiled by the Treasury Department, estimates that if all business-to-business, nonprofit and medical services transactions were excluded from taxation, the potential annual yield of a sales tax on services would be approximately $1.65 billion.

Services	FY 2010 estimates ($s in millions)
Cable/Satellite TV	$48.6
Entertainment admissions	$95.1
Amusement and recreation (skiing, golfing, bowling, fitness centers)	$98.4
Dry cleaning	$31.5
Landscaping	$62.6
Vended food	$29.5
Personal care services	$89.9
Other personal care services	$104.3
Child care	$44.0
Ground transportation	$22.7
Real estate services	$112.7
Personal share of professional services (including investment advice, legal, accounting, and insurance services)	$240.9
Waste collection (including government contracted)	$45.2
Service contracts	$28.8
Construction (excludes government and business to business)	$299.0
Death care services	$20.4
Repair and maintenance	$220.6
Other services (security, towing, residence care, storage)	$53.9
Total	**$1,648.1**

Expanding the sales tax to these services and others was attempted in Michigan in 2007 but the effort failed. The final legislation taxed a relatively small list of services, and appeared haphazard and illogical. As a result, there was little public support for such an expansion to the sales tax. With school districts closing schools, services to families being cut and road repairs being put on hold, the public is now beginning to see the need for increased revenue. Recent polling shows that 59 percent of the public supports expanding the 6 percent sales tax to nonessential and luxury items such as spa services, entertainment, and recreation.[11]

A More Equitable Tax

In addition to increasing revenue to fund public education and vital services such as police and fire departments, expanding the sales tax to additional services is a more equitable way of taxing consumption. Sales taxes are a regressive tax as the tax is imposed on the spending of all individuals across the income spectrum. According to a 2007 study by the Institute on Taxation and Economic Policy, Michigan families with the lowest incomes (less than $15,000/year) devote more than 7 percent of their income to

[9] Mazerov, M. (2009). *Expanding sales taxation of services: Options and issues*. Retrieved from The Center on Budget and Policy Priorities website: http://www.cbpp.org/files/8-10-09sfp.pdf

[10] Feasibly taxable services consists of all services consumed by households except the following: housing, health care, education, transportation, legal, funeral and some insurance and banking services.

[11] Epic-MRA, *Statewide poll-September 2009*. (2009). Retrieved from http://epicmra.com/press/Stwd_Survey_Sep2009_Media_Freq.pdf

sales taxes while the top 1 percent of Michigan families (income of $365,000/year or more) spend just 1 percent of their income on sales taxes.[12]

Much of this is due not only to the fact that lower-income families spend a higher percentage of their disposable income on goods such as clothing, but because Michigan also taxes goods everyone uses, such as gas and electricity, but not luxury items such as pet grooming or spa services. In addition, upper-income households tend to save more while lower-income households have less income to save and spend their income on taxable goods.

By expanding the sales tax base to include more services, including those such as car and appliance repair, services all people utilize would be taxed, including those used by low-income households. However, expanding the sales tax to only include services typically purchased by upper-income families would exclude a large portion of potential revenue, thus making an expansion to more services less effective. The increased tax burden placed on lower-income families by taxing services that are used by a large portion of the population can be counteracted through tax credits such as the Earned Income Tax Credit.

Conclusion

Michigan's budget shortfalls will continue until a comprehensive restructuring of the state's revenue system is undertaken. Constant cutting and temporary revenue increases (such as the temporary increase in the income tax rate) have failed to provide adequate revenue. In addition to expanding the sales tax to include more services, other pieces of a comprehensive solution and balanced approach could include examining tax loopholes and implementing a graduated income tax.[13]

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[12] Davis, C., Davis, K., Gardner, M., McIntyre, R.S., McLynch, J., & Sapozhnikova, A. (2009). *Who pays? A distributional analysis of the tax systems in all 50 states.* Washington, DC: Institute on Taxation & Economic Policy.
[13] For more information please see the Michigan League for Human Services' series, *Facts Matter*, a series of briefs highlighting Michigan's budget and tax system available at http://www.milhs.org/information/default.asp?NavPageID=75775