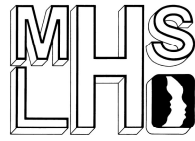


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## Michigan League for Human Services



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### A Sales Tax for a Modern Economy: Expanding Michigan's Sales Tax to Services

As Michigan's fiscal situation continues to worsen, interest in the need for revenue-generating strategies as a means of handling the fiscal crisis and addressing the structural deficit is growing. One avenue being discussed in many states with similar fiscal problems is modernizing the sales tax by broadening the base to include services—the fastest growing sector of today's economy.

Services have not been a major part of the sales tax base in most states, largely as a result of the historical circumstances in which the sales tax was enacted. In 1930, just as the Great Depression was beginning, Mississippi was the first state to enact a sales tax. By the outbreak of World War II, 23 other states had enacted a sales tax. Cash-strapped states desperately needed revenues quickly in order to replace property taxes, which were eroding rapidly. At that time it made sense, for a variety of reasons, to focus the tax on the sale of tangible goods. In particular, the production and sale of goods were the dominant features of the economy as it existed in the 1940s.

Today, however, services are a major component of the economy. According to the Center on Budget and Policy Priorities, household consumption of services (including those related to housing) exceeded household consumption of goods for the first time in 1982. In 2001, household purchases of services represented 58.8 percent of personal expenditures. Despite this significant change in the economy, a majority of states apply their sales tax to less than one-third of 164 potentially taxable service categories, according to the Federation of Tax Administrators.

While most states are not taking full advantage of the revenue potential of an expanded sales tax, Michigan in particular taxes very few services. Of the 164 service categories listed by the Federation, Michigan taxes only 29—primarily utilities.

#### Number of Services Taxed *Out of 164 Service Categories*

Illinois	17
Indiana	22
Iowa	94
<b>Michigan</b>	<b>29</b>
Minnesota	61
Ohio	52
Wisconsin	69

*Source: Federation of Tax Administrators, 1996*

The fact that Michigan taxes so few services has a significant impact on the potential revenue that is lost as a result. In Michigan, nearly three-fourths of sales tax revenues are allocated to the School Aid Fund (SAF), representing over 40 percent of total SAF revenues. Services, however, are the largest single exclusion from the state's sales tax base. The estimated loss of revenue in Fiscal Year 2005 due to the exemption of services is \$8.6 billion, compared to \$4.6 billion in Fiscal Year 2001. As the service sector continues to grow in economic importance, this figure will continue to increase. However, Michigan will forego nearly \$11 billion in sales tax revenues in FY2004, with \$7.3 billion –two-thirds –attributable to the absence of a tax on most services purchased by households and businesses.

### What Could Be Taxed?

Michigan has many options for broadening the sales tax base. The Center on Budget and Policy Priorities suggests three possible categories of services:

- Services primarily purchased by businesses, such as payroll processing and television advertising;
- Services primarily purchased by households, such as hair care and cable TV; and
- Services purchased by both households and business, such as landscaping and pest control.

Most states have avoided taxing the first category, often referred to as “business-to-business” sales, and have instead targeted household services or a mixture of household/business services. (See chart, *State Sales Taxation of Selected Household Services*.) Many states also avoid taxing health care services.

Examples of services that  
could be taxed in Michigan include:

Dating services	Landscaping services
Storage services	Travel agent services
Investment counseling	Carpet cleaning
Veterinary services	Health clubs, tanning parlors, etc.
Security services	Interior design and decorating
Information services	Automotive services
Parking	Admission to events
Chartered flights	Limousine service and rental
Hair/nail care	Labor on installation and repair

State Sales Taxation of Selected Household Services  
("T" = taxable)

	A L	A Z	A R	C A	C O	C T	D C	F L	G A	H I	I D	I L	I N	I A	K S	K Y	L A	M E	M D	M A	M I	M N	M S			
Veterinary services										T																
Horse boarding/training										T																
Pet grooming										T					T								T			
Landscaping/lawn care			T			T	T			T			T	T	T								T	T		
Self storage		T						T		T				T												
Marina services		T	T				T	T		T					T									T		
Residential electricity	T	T	T						T	T		T	T	T			T	T				T	T			
Residential gas	T	T	T						T	T		T	T	T			T					T	T			
Investment counseling										T				T												
Barber shops/salons										T				T												
Carpet/uphol. cleaning		T				T				T				T			T							T		
Dating services						T				T				T												
Diaper service	T	T							T	T			T	T	T		T							T		
Garment alter./repair						T	T	T		T				T	T		T							T		
Health clubs			T							T	T			T	T									T		
Laundry/dry cleaning							T			T				T	T		T		T					T	T	
Personal instruction						T				T																
Shoe repair			T			T	T	T		T				T	T		T					T		T		
Swimming pool clean.			T			T	T			T				T	T									T	T	
Tuxedo rental	T	T	T	T		T	T	T	T	T	T		T	T	T	T	T		T			T		T		
Exterminating						T		T		T	T			T	T									T	T	
Auto washing			T			T		T		T				T	T									T	T	
Auto road svc./towing										T				T	T									T		
Auto maint./painting			T			T	T	T		T				T	T		T							T	T	
Parking lots/garages		T	T			T	T	T		T				T			T							T	T	
Auto rustproofing		T	T			T	T	T		T				T	T		T							T	T	
Parimutuel racing adm.		T	T			T		T	T		T			T	T	T			T					T	T	
Amusement park adm.	T	T	T			T	T	T	T	T	T			T	T	T	T		T					T	T	
Bowling alleys	T	T	T			T		T	T	T	T			T	T		T							T	T	
Cable TV			T			T	T	T		T			T	T	T			T	T					T	T	
Circus/fair adm.	T	T	T			T	T	T	T	T	T			T	T	T	T		T					T	T	
Private club membersh.		T				T		T		T				T	T		T							T		
Cultural event adm.	T	T	T			T		T	T	T	T			T	T	T			T					T		
Prof. sports adm.	T	T	T			T	T	T	T	T	T			T	T	T	T		T					T	T	
Private limo svc.		T				T	T		T	T				T												
Labor chg., auto repair			T			T	T	T		T				T	T		T								T	
Labor chg., TV repair			T			T	T	T		T				T	T		T								T	
Labor chg., remodeling		T								T				T												
Extended svc. contracts			T	T	T	T	T	T		T	T	T		T	T		T								T	
Installation charges					T			T		T					T		T								T	T
# of these services taxed	9	18	22	2	2	25	18	22	11	39	10	3	6	34	27	6	20	2	8	0	4	24	21			

Source: Federation of Tax Administrators, *Sales Taxation of Services: 1996 Update*, Research Report No. 147 (Washington, DC: Federation of Tax Administrators), April 1997. Partially updated for known changes. See report for extensive footnotes that affect classification as taxable or exempt. Available at [www.taxadmin.org/fta/pub/services/services.html](http://www.taxadmin.org/fta/pub/services/services.html).

M	N	N	N	N	N	N	N	O	O	P	R	S	S	T	T	U	V	V	W	W	W	W	
O	E	V	J	M	Y	C	D	H	K	A	I	C	D	N	X	T	T	A	A	V	I	Y	
				T									T										Veterinary services
					T								T	T						T			Horse boarding/training
T			T	T	T					T			T	T	T	T				T	T		Pet grooming
				T	T			T		T			T		T				T	T	T		Landscaping/lawn care
				T	T								T							T			Self storage
T			T	T	T			T		T			T	T		T			T	T	T	T	Marina services
	T			T		T							T			T				T	T	T	Residential electricity
T	T			T		T	T						T			T				T	T	T	Residential gas
				T									T										Investment counseling
				T									T										Barber shops/salons
				T						T			T	T	T					T	T		Carpet/uphol. cleaning.
				T	T								T		T				T	T			Dating services
	T			T		T		T				T	T	T	T	T		T	T	T		T	Diaper service
				T				T					T	T	T	T			T	T	T	T	Garment alter./repair
T	T			T				T				T	T	T	T		T			T	T		Health clubs
				T		T				T		T	T	T	T	T			T	T	T	T	Laundry/dry cleaning
				T									T							T			Personal instruction
				T				T					T	T	T	T			T	T	T	T	Shoe repair
			T	T	T			T					T		T				T	T	T		Swimming pool clean.
	T	T		T	T	T	T	T	T	T		T	T	T	T	T	T	T	T	T	T	T	Tuxedo rental
	T			T	T	T		T		T			T		T				T	T			Exterminating
	T			T	T	T		T		T			T	T		T			T	T	T	T	Auto washing
	T			T	T	T				T			T	T					T	T	T	T	Auto road svc./towing
	T			T	T	T		T		T			T	T		T			T	T	T	T	Auto maint./painting
				T	T				T				T	T	T				T	T	T		Parking lots/garages
	T	T		T	T			T		T			T	T		T			T	T	T	T	Auto rustproofing
T	T			T		T	T		T				T	T	T	T	T			T	T	T	Parimutuel racing adm.
T	T			T	T	T	T		T			T	T	T	T	T	T			T	T	T	Amusement park adm.
T	T			T			T		T			T	T	T	T	T	T		T	T	T		Bowling alleys
	T			T							T	T	T	T	T		T			T	T		Cable TV
T	T			T	T	T	T		T			T	T	T	T	T	T			T	T	T	Circus/fair adm.
T	T			T	T		T	T	T			T	T	T	T		T			T	T		Private club membersh.
T	T			T	T		T	T		T			T	T	T	T	T			T	T	T	Cultural event adm.
T	T			T	T	T	T		T			T	T	T		T	T			T	T	T	Prof. sports adm.
				T					T				T					T		T		T	Private limo svc.
			T	T	T			T		T			T	T		T			T	T	T	T	Labor chg., auto repair
			T	T	T			T		T			T	T	T	T			T	T	T	T	Labor chg., TV repair
			T	T	T								T		T				T	T			Labor chg., remodeling
	T			T	T	T		T		T		T	T	T	T	T		T	T	T	T		Extended svc. contracts
	T			T	T	T		T		T			T	T	T	T			T	T	T	T	Installation charges
11	20	2	17	39	23	10	9	17	10	15	1	12	40	27	24	22	10	4	21	3	2	2	#of these services taxed
																				7	9	1	

One service category taxed by most states, which is entirely discretionary spending, is admission to entertainment, amusements and recreation. In Michigan this category would include: performing arts, spectator sports, race tracks, college sports, bowling, museums, amusement parks, gambling, golf, country clubs, ski resorts, marinas and fitness facilities. Expanding Michigan's sales tax to just this category of services alone is estimated to yield over \$200 million annually.

### Minimizing the Regressivity of the Sales Tax

One concern that is often raised about expanding the sales tax base to include services is the fact that the sales tax is very regressive. According to a recent study by the Institute on Taxation and Economic Policy (ITEP), the 20 percent of families with the lowest incomes devote 5.9 percent of their incomes to paying sales tax, while the most affluent one percent of families devote just one percent of their incomes to paying the tax.

Michigan's sales tax was increased from 4 percent to 6 percent in 1994 with passage of Proposal A, further increasing the regressivity of the tax and the burden on low-income households. Although the sales tax burden in Michigan is mitigated somewhat by the exemption of food and prescription medication from taxation as a result of an amendment to the state's Constitution adopted in 1974, a sales tax on some services could increase the burden on low-income taxpayers. It should be noted that experts caution against extending the sales tax to services purchased primarily by more affluent households because of the relatively low revenue gain that would result. Taxation of a broader range of services would ensure a higher revenue yield.

There are several ways to ensure that expanding the sales tax base would not adversely affect low-income households. One approach is to lower the sales tax rate, but in a manner that makes the change revenue neutral. It is critical during a period of significant fiscal pressure that additional revenue not be foregone as a result of a change in the sales tax rate or base. Increasing a state's income tax, particularly on higher income households, would also help to offset the impact of an expanded sales tax base, but Michigan has a flat income tax, which is also regressive. Another approach for ensuring that an expansion of the sales tax base does not have an adverse impact on low-income households is to specifically target tax relief to these households through mechanisms such as a state Earned Income Tax Credit.

### Conclusion

Consumption has been shifting from goods to services for several decades and this trend is not likely to change. Therefore, taxing some services would appear to be essential to maintaining a revenue base over the long term that could match the need for government services.

Michigan currently faces a projected deficit of at least \$1.2 billion for Fiscal Year 2005 and 2006, and average annual deficits of at least \$400 million —nearly \$5 billion over the next decade. Expanding the sales tax to certain services would provide an alternative to making deep and painful cuts in spending and would be a first step toward improving the stability and guaranteeing the adequacy of Michigan's tax structure.