New Sales Tax Pitch: Michigan Revisits Idea of Expanding Base; Will Other States Follow?

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In fall 2007, with a $1.7 billion deficit to fix and a deadline to avoid a government shutdown a few hours past, Michigan lawmakers narrowly approved a budget-balancing plan that included a mix of government reforms and tax increases.

The plan, in part, expanded the state’s sales tax base to include more services — a move that states have considered for many years as a way not only to bring in additional revenue, but to get their tax structures more in line with changes in consumer spending.

The expansion in Michigan, however, didn’t last long.

The politically unpopular sales tax measure was repealed two months later, before it even took effect.

This year, still dealing with a fiscal and economic crisis, some Michigan legislators are renewing their push for an expansion of the state sales tax, as part of an overall strategy to balance the budget and restructure the tax system.

Whether they are successful or not remains to be seen, but past history in not only Michigan, but other states, makes it clear that there are significant policy and political hurdles that will have to be overcome.

Changes in economy, but not tax

The consumption of services has been making up a greater and greater part of state economic activity for several decades now. In 1950, 60 percent of consumer purchases in Michigan were for “hard goods” and 40 percent were for services, Rep. Mark Meadows [6] says.

“It’s completely reversed today,” the East Lansing Democrat adds. “Services make up [close to] 70 percent now.”

Michael Mazerov, a senior fellow with the Center on Budget and Policy Priorities, details the national
trends in a study [7] released last year. In 2007, the consumption of services accounted for 45 percent of total household purchases, compared with 31 percent of total purchases in 1970.

Over this time period, rather than respond to the change in consumer spending by expanding the tax base, states were more prone to enact across-the-board rate increases, Mazerov says. And since 2007, even with states facing massive budget deficits, there have been only a few instances of significant sales tax expansions (the most notable example being Maine, which has begun to tax entertainment admissions, auto and equipment repairs, and various other services).

“I think the big story is that despite many policy analysts and economists seeing this is a major flaw in tax systems, not much has been done,” Mazerov says.

As a result, many states’ decades-old sales tax systems are open to charges of being not only antiquated, but inequitable. For example, a state is likely to tax a person who rents a videotape (considered the purchase of a tangible good), but not a person who watches a pay-per-view movie on cable TV (considered the purchase of a service), Mazerov notes in his 2009 study.

Yet attempts to expand the sales tax base have more often than not failed due to a variety of factors.

First, the idea of adding to the tax burden of individuals and businesses is never popular or desired, especially during a period of economic uncertainty. Second, there is the question of whether states should rely more heavily on a regressive source of revenue like the sales tax. Third, there are concerns that, with an expansion, states would begin levying taxes on too many business-to-business transactions — a type of “tax pyramiding” that many economists warn against.

Finally, defining different services in statute — deciding how and what to include and exclude in the tax base — can soon become a problematic legislative task.

Meadows believes one reason that his state’s 2007 proposal ultimately failed was that it had “obvious winners and losers within a particular industry.” The tax was extended to golf and bowling, for instance, but not to skiing.

“There wasn’t a thoughtfulness to how we did it,” he says.

But even with a lot of thought, there are difficult decisions to make. Meadows uses the example of taxing legal services. It seems reasonable, he says, that a lawyer’s services in helping someone write a will would be taxed. But Meadows adds that the policy question becomes more difficult when deciding whether a defendant accused in a crime should have to pay a tax on the legal services he or she receives.

Still, Meadows hopes the lessons learned in 2007 help him and other proponents shepherd the sales tax expansion through the Legislature. His proposal (HB 5527 [8]) would extend the sales and use tax to all services, with four exceptions: business-to-business, education, nonprofit and physician services.

“My view is that there should be very few exceptions,” says Meadows, who expects the big fight over the bill to center around the proposed taxation of legal, accounting and real estate services.

The proposal calls for reducing the sales tax rate from 6 percent to 5 percent and dedicating much of the increased revenue from the expansion to local schools and governments. His plan would also cut Michigan’s business tax on gross receipts by 44 percent and eliminate a business surcharge, a restructuring that Meadows says will make the state more economically competitive.
Those business-tax cuts have helped garner the support of manufacturers and other companies. And Meadows hopes a constitutional guarantee that revenue from the expansion goes toward hard-hit local schools and governments helps mobilize public support.

A cut in the rate, too, could ease concerns about the regressivity of the sales tax.

Still, the idea of any kind of revenue enhancement (even if part of the plan cuts taxes in other areas) will likely be a tough sell.

Michigan Senate Republicans have unveiled a government reform plan that they say would eliminate the deficit without tax increases. Key components of the proposal include a 5 percent cut in state employee salaries, an increase in the amount employees pay for health insurance, state and local government consolidation, and the elimination of Medicaid services that federal law does not require to be covered.

Wide variances in states’ tax bases

To this point in the current fiscal crisis, most states in the Midwest have not raised taxes; none has expanded the sales tax base in any comprehensive way.

Mazerov believes that will change if the revenue outlook for states does not brighten soon. During the budget downturn at the start of this decade, a handful of states (including Nebraska) extended sales tax bases as part of their budget-balancing plans.

According to Mazerov’s calculations, a state like Illinois — which currently taxes a relatively small number of services — could increase its sales tax revenues by as much as one-third by expanding the base to include all household services.

On the flip side, a state like South Dakota — which does not have a state income tax and has long relied heavily on the sales tax as a revenue source — already taxes a broad array of services. In fact, South Dakota could serve as a model for other states wanting to significantly expand their sales tax base.

Under South Dakota statute, services are presumed to be taxable, unless lawmakers spell out exceptions. (In many states, the opposite is true: Services are not taxed without an action taken by the legislature.) As a result, South Dakota is able to capture more services and automatically include new ones as they are introduced into the economy. One downside to the South Dakota approach, Mazerov says, is that it captures business-to-business transactions, which many states would like to avoid taxing.

Another concern is that a comprehensive expansion of the sales tax would cause an administrative headache for states and the businesses being brought into the system for the first time.

Still, the combination of fiscal problems and concerns about antiquated sales tax systems could make proposals such as the one in Michigan more common.

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