Among many spending and tax reforms, Governor Jennifer Granholm proposes a 2% excise tax on services in her FY 2008 Budget. The state would impose the tax on services purchased by both consumers and businesses in Michigan. This new tax would provide substantial additional revenue while also creating many new economic distortions and costs. Instead, Michigan should expand the current retail sales tax base (which exempts firms’ intermediate purchases) to include non-exempt consumer-purchased services.

**BACKGROUND**

The proposed excise tax would levy 2% on the gross receipts of any “person performing or delivering a service received in the state.” As mentioned above, both consumers and businesses purchasing services would be subject to the tax. Such services include recreation services, legal services, construction services, etc. However, the state would exempt some essential and “public interest” services from the new tax, including health care, public transit, and educational services. Some organizations would also be exempt under certain conditions, including nonprofits, religious organizations, and governments (similarly exempt from other taxes).

The Michigan Department of Treasury estimates the tax would generate $1.47 billion in additional revenue for FY 2008. Roughly 70% will come from taxes on business purchases, and consumers will cover the remaining 30%. Various professional and construction services make up most of the firms’ levy. Recreation, personal, and repair services make most of consumers’ projected share. Over the past several decades, both the national and Michigan economies have transitioned from being heavily goods-based to more service-based. This trend has gradually eroded the revenue potential of the traditional retail sales tax. Thus, Michigan can supplement this eroding revenue by broadening the base of consumption taxes to include services while exempting certain purchases on equity and efficiency ground as discussed below.

**TAX ANALYSIS**

**Efficiency**

Generally, broadening the sales tax base increases economic efficiency because consumers can shift less of their consumption toward untaxed substitutes. However, the new excise tax is still a new tax. It would not be offset by a reduction in other taxes or rates. Thus, it would invariably alter the consumption behavior of both firms and individuals to some degree. One could argue that any new distortions would be at least partially offset by reductions in those created by the original exemption of most services. However, distortions would persist because the state would continue to tax goods and services at different rates. Currently, the difference is 6% versus 0%.
The proposed tax changes it to 6% versus 2%. Thus, the relative price differences between taxed and untaxed good and services would diminish under the new tax, thereby decreasing some of the previous economic distortion. If Michigan taxes goods and services equally, then it could minimize any substitution due to relative price differences.

Another commonly cited efficiency cost of sales taxes is the incentive to increase consumption in other jurisdictions not subject to the tax (i.e. “border effects”). However, consumers tend to limit some services to their immediate location, particularly in the case of personal services where they may have an established or personal relationship with the service-provider. Moreover, the academic literature suggests that the “overall influence on location is likely to remain modest, and broadening the base may have effects which are no larger than those from increasing the sales tax rate, or taxing another source.”6 Firms may be more likely than consumers to cross jurisdictional lines to purchase services, especially professional services like advertising. Thus, if Michigan aims to increase its revenue through additional taxes on either consumer or firm consumption, it cannot help but introduce at least a small degree of locational distortion.

The proposed service tax would lead to a number of additional economic distortions because it applies to business purchases. First, it leads to double-taxation of the final goods and services purchased by consumers. For example, if a firm pays an accounting firm to do its inventory, it would pay an additional 2% under the proposed tax. The firm could then pass this extra cost onto its consumers as a higher price on the goods and services it sells. Then, the consumer would pay a sales or service tax on top of the tax-induced higher price. Thus, consumers ultimately bear multiple taxes on a single purchase.

Second, firms might choose to vertically integrate to avoid the service tax even if it would be normally inefficient.7 Following the same example, the new tax may induce the firm to hire its own accountants if the additional tax costs are greater than the additional personnel costs (especially if it cannot easily pass the tax onto consumers). Third, a tax on intermediate purchases of services but not goods puts firms that rely more heavily on services as inputs at a competitive disadvantage relative to those relying mostly on goods as inputs.8 Currently, the state does not tax intermediate goods purchased by firms to avoid the problems above. Similarly, Michigan can avoid these efficiency costs by exempting services purchased by firms.

Equity

Like the traditional retail sales tax, firms bear the immediate legal incidence of the excise tax. They collect an additional 2% on every sale and send the revenue to the state treasury. This would likely entail additional administrative costs discussed in greater detail in the section below. Most firms will directly charge the 2% tax at the time of consumer purchases. When firms purchase services as inputs, they can also imbed that additional cost in higher consumer prices (i.e. double-taxation discussed above). Ultimately, consumers bear most of the economic incidence of the new tax except for cases where they can readily seek untaxed substitutes (e.g. services in other states) or otherwise change their behavior.

Horizontal equity requires that taxpayers with similar incomes or circumstances bear equal tax burdens. An excise tax on services would improve the horizontal equity of the sales tax when
the two are taken together. Why should two comparable taxpayers pay different amounts of sales tax when their consumption levels differ only by their relative proportions of goods versus services? Even though the proposed excise tax rate (2%) would not be as high as the prevailing sales tax rate (6%), it does at least approach this standard of horizontal equity for consumers. Conversely, the proposed excise tax creates horizontal inequities among firms because intermediate purchases of services are taxed while goods are not. Like consumers before the new tax, relatively equal firms would bear different tax burdens because of their relative preferences for goods versus services in the production process. The state can best improve horizontal equity by exempting firms’ purchases of intermediate services and taxing goods and services at equal rates.

Vertical equity requires that taxpayers with different abilities to pay bear different tax burdens. Generally, sales taxes are seen as regressive since low-income individuals spend a greater share of their incomes on consumption compared to middle- and high-income citizens. Often, this is mitigated through exemptions such as the common one for food purchases. Similarly, the proposed excise tax mitigates additional regressivity by exempting health care, transit, and educational services. These services tend to either essential to a consumer’s livelihood or generate positive externalities.

As previously mentioned, individuals would pay their largest shares of the new tax in recreation, personal, and repair services. Arguably, higher-income individuals consume greater quantities of these non-essential services than lower-income individuals. Moreover, higher-income individuals tend to purchase more expensive versions of these services (e.g. high-priced haircuts). However, studied have shown that service taxation tends to remain regressive for low-income individuals but proportional among middle- and high-incomes classes. Specifically, Florida experienced this trend when it instituted a service tax. While the new tax would not be progressive, these factors (particularly the exemptions) mitigate some of its most regressive elements. Conversely, studies have shown that service taxes are least regressive when firms’ intermediate service purchases are included because the impact on consumers is broadly diffused. If Michigan is most concerned about the equity impacts of taxing services, it should consider keeping the provision that includes firms’ service purchases.

Administration

While the administrative costs of increasing the sales tax rate (while holding the base constant) entails negligible costs to the government and firms, the cost of expanding the base can go either way. Firms that never collected sales taxes previously will incur substantial costs to modify their transaction systems, and the state will bear additional costs to register and monitor those firms’ compliance. On the other hand, firms that previously collected sales tax on goods will incur comparatively lower costs in incorporating these additional transactions. They will no longer have to distinguish transactions between taxable and nontaxable for accounting purposes but instead simply between general sales tax and service excise tax. If services were included in the general sales tax rather than a separate tax, then these firms could actually save money by not having to make any distinctions at all. Thus, Michigan may absorb high initial costs for taxing services, but monitoring the new firms would be the primary recurring cost.
Adequacy and Stability

As discussed above, Michigan can raise substantial additional revenue by taxing services. It may even make up for revenue lost due to consumption patterns that have shifted more toward services. However, the exemptions, whether for particular services or for firms, undermine the revenue potential of the tax. The state will need to either make up the foregone revenue with other taxes or a higher rate structure. Generally, sales tax revenue is relatively unstable. That is, sales tax revenue decreases during a recession or a milder economic downturn when individuals cannot afford to consume quite as many taxable goods (necessities are generally not taxed). Normally, expanding the tax base would provide additional stability since a broader base shares in any economic decline.

However, the evidence on taxable services as a stabilizer is mixed. It appears that general service consumption remains relatively constant across business cycles. However, once the state exempts essential services (e.g. health care), some of this stabilizing power is diminished. Moreover, if Michigan relies heavily on taxes from firms’ service consumption, then an economic downturn may destabilize the stream of tax revenue. For instance, if construction services make up a considerable share of firms’ service consumption and firms have to postpone these improvements during a recession, then the state revenue from the tax will invariably decline. Regarding exemptions, Michigan faces a trade-off between equity and stability as it does with equity and efficiency.

RECOMMENDATIONS

Extend the Sales Tax Base to Consumer Services

Rather than a 2% excise tax on services, the state should expand the current retail sales tax base to include services. A separate tax on services at a lower rate would still maintain price differentials between goods and services, thus mitigating the potential efficiency gains. The state can raise more revenue if services are taxed under the 6% sales tax. The state can also decrease the sales tax burden by expanding the base to include services and reducing the 6% rate. In either case, the state would find it easier to administer the service tax by folding it into the current sales tax system rather than setting up a second-tier excise tax. Crafting a comprehensive list of taxable services and informing current retailers may take time and resources, but those costs will decline substantially after the tax change has been institutionalized over time.

Exempt Firms’ Intermediate Purchases of Services

If Michigan folds services into the current retail sale tax, then firms’ intermediate service purchases should be exempt since the state does not tax goods used as inputs. Firms’ service purchases comprise nearly 70% of the tax revenue under the proposed excise tax. Thus, exempting those purchases dramatically undermines the revenue potential of taxing services. However, taxing those purchases creates substantial efficiency costs as well. Michigan can make up some of the foregone tax revenue from firms if it taxes service consumption along with goods at 6% or another rate higher than 2%. Exempting firms’ purchases may also increase the tax’s regressivity. However, the other proposed exemptions also mitigate regressivity.
**Maintain Proposed Exemptions**

The proposed excise tax calls for several exemptions of essential services such as health care. Any exemption creates efficiency costs and reduces the tax’s overall revenue potential. Moreover, these service exemptions compromise some of the largest service expenditures in the economy. However, consumption taxes are typically regressive, and taxing these essential services would only worsen that condition. Moreover, the state has an interest in encouraging consumption of educational services and preventative health care. While these exemptions may create economic distortions, they can also achieve positive externalities.

While it entails several benefits and costs, expanding the sales tax base to include most services stands to significantly enhance Michigan’s tax revenue. It broadens the consumption tax base to tap into an economic sector largely untouched both in Michigan and nationwide. If sales taxes are ostensibly taxes on consumption, then the state should not discriminate between consumptions of goods versus services. In fact, doing so creates economic inefficiencies and horizontal inequities. The initial costs in establishing the new tax would be considerable both for firms and the state. However, these administration costs would decline after the initial adjustment period. While some exemptions will alleviate some of the regressivity that a service tax would create, those same exemptions create new economic distortions and limit the revenue potential of the tax. Overall, the largest costs are reduced under the recommendations above while maintaining many of the benefits of taxing services.

**REFERENCES**

3. Ibid., 1-4.
5. Ibid., 7.
11. Ibid., 48.
13. Ibid., 24.