



Tax Changes in Michigan: Measuring the Effects of Expanding the Sales Tax to Services

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As part of her new budget, Governor Jennifer Granholm has proposed a tax and spending plan aimed at closing a state deficit that published reports indicate to be around \$900 million for fiscal year (FY) 2007.¹ The contraction in the state's automobile sector resulting from increased competition from out-of-state and foreign manufacturers is taking a serious bite out of the growth in revenue collections, particularly sales and income taxes. The estimated budget deficit for FY 2008 now stands at about \$1 billion.²

The governor's budget includes several proposals to increase taxes to alleviate the state's financial situation, with the most significant being a 2% state-imposed excise tax on many services, effective June 1, 2007. The proposed excise tax would apply to more than 100 services, including landscaping, movie tickets, legal services, sporting events, amusement parks, bowling alleys, marinas, dating services, golf greens fees, and repair services. Health care and education expenditures, services purchased by the federal, state and local governments and nonprofit organizations, and admissions to museums and historical sites would be exempt.³

Governor Granholm expects the new excise tax to raise approximately \$477 million in the last quarter of FY 2007 and \$1.47 billion in FY 2008, its first full year of implementation.⁴ However, the governor's estimate fails to consider the negative effects on jobs, investment and personal income that would result from the tax increase. The governor's estimates are based on the "static" assumption that individuals and businesses will not respond to the economic disincentives posed by the new taxes. In fact, however, a tax increase of this magnitude will exert measurable, negative effects on economic activity.

¹ David Eggert, "Granholm says state can't cut its way out of deficit," available at <http://www.lansingstatejournal.com/apps/pbcs.dll/article?AID=2007703060339> Internet; accessed 1 March 6, 2007

² *Ibid.*

³ State of Michigan, Office of the State Budget, "Tax Restructuring Proposal"; available at http://www.michigan.gov/documents/C1-6_115969_7.pdf; Internet; accessed 1 March 2007, B-3.

⁴ *Ibid.*, B-3.

Taking these “dynamic” effects into account, the Mackinac Center for Public Policy asked The Beacon Hill Institute at Suffolk University to provide an independent estimate of the new revenue the governor’s proposal will actually raise. Table 1 provides revenue estimates for FY 2007-FY 2008. The first row shows the governor’s static estimate of the additional revenue that would be raised by imposing the 2% excise tax on services, the second row shows our dynamic estimate and the third row shows the difference between the two.

Table 1. Effects of Proposed New Service Excise Tax on Michigan’s Tax Revenue (\$ millions)		
	FY 2007	FY 2008
Governor’s Static Estimate	477	1,470
BHI Dynamic Estimate	306	1,249
Difference	171	221

The dynamic economic effects of the tax increase exert a negative impact on revenue. The state can expect to add no more than \$306 million to its FY 2007 revenue collections rather than the \$477 million estimated by the governor. In its first full year of implementation, the tax could be expected to generate about \$1.25 billion in additional revenue, which is also below the governor’s estimate of \$1.47 billion. BHI estimates that the service tax will produce \$171 million less revenue than the governor’s estimate for FY 2007 and \$221 million less revenue in FY 2008, as seen in Table 1.

The excise tax would expand the sales tax to services in Michigan at the same time that bordering states like Ohio and Illinois, which tax relatively few services, would not.⁵ As a result, the imposition of the excise tax on services in Michigan would cause a portion of service-related business to shift to providers in other states, especially in towns just across the border. While the language of House Bill 4368 indicates that Michigan would collect the excise tax on these “imported” services, the enforcement of the tax would prove extremely difficult. Consumers routinely purchase goods in states with no sales tax

⁵ Federation of Tax Administrators. 2004 Survey on State Taxation of Services. Internet, available at <http://www.taxadmin.org/fta/pub/services/services04.html>.

and transport them back to their home state without paying the use (sales) tax in their home state. Services are even more problematic because often there is nothing physical to transport across borders. One could even argue that the service is consumed in the other state.

Table 2. Estimates of Effects of New Michigan Service Excise Tax		
Variable	FY 2007	FY 2008
Employment (jobs)	-4,920	-19,561
Wages(\$)	-110,105,728	-409,169,927
Investment (\$)	-60,317,298	-248,341,770
Personal Income (\$)	-286,941,224	-1,189,763,254

The erosion of the tax base would inflict harm on the Michigan economy. Table 2 summarizes our findings regarding collateral damages due to the new tax. (Please note that the FY 2008 numbers are cumulative. That is, they include job, wage, investment, and personal income declines from FY 2007.) The tax increase would cause job losses in service-related sectors and spill over into non-service industries. We estimate that the tax would destroy 4,900 jobs in the final quarter of FY 2007 and a cumulative total of almost 20,000 jobs in FY 2008. The job losses would contribute to a drop in total wages by \$110 million in FY 2007 and a cumulative total of nearly \$410 million in FY 2008. Investment would decline by an estimated \$60 million in FY 2007 and by a cumulative total of almost \$250 million in FY 2008. The excise tax cannot raise revenue without directly impacting the income of Michigan citizens who are already facing a poorly performing state economy. The tax increase would reduce state personal income by \$287 million in FY 2007 and a cumulative \$1.2 billion in FY 2008.

Governor Granholm's intention to tax services will help reduce a state budget deficit caused by a weakened state economy. However, the tax increase will yield less revenue than she hopes to raise and will hurt the state's economy in the process. Policymakers in Michigan should be careful not to inflict more economic hardship on taxpayers who are already suffering from a weak economy.

Data Sources and Methodology

We used sales tax revenue estimates from the Michigan Department of Treasury as a baseline scenario that assumes (1) no change in the tax code; and, (2) the expected growth rates for the Michigan economy through FY 2008.⁶ Because no one knows what components of the governor's plan will be passed into law, the Mackinac Center asked the Beacon Hill Institute to measure the impact that the primary component would have on the state's economy should this component alone be adopted (all other things being equal).

For this scenario, Michigan sales tax revenue would be \$1.5 billion for the last quarter of FY 2007 and \$6.4 billion for FY 2008. We used the tax revenue estimates provided in the "Tax Restructuring Proposal," published by the Office of the State Budget, as the static revenue figures.⁷ The report estimated that the state could expect to raise \$477 million and \$1.47 billion in the last quarter of FY 2007 and in FY 2008, respectively, by imposing the 2% service excise tax. These figures assume minimal erosion of the sales tax base and no collateral or economic damage to revenue collections. We estimated the dynamic revenue the state could expect from imposition of the tax, given the expected erosion of the tax base and collateral economic damage.

To predict the effect the new excise tax on services would have on tax revenues and the economic variables (jobs, wages, investment and personal income), we employed the Beacon Hill Institute State Tax Analysis Modeling Program (STAMP) models.

STAMP is a "computable general equilibrium" (CGE) tax model — a computerized method of accounting for the economic effects of tax policy changes. A CGE model is specified in terms of supply and demand for each economic variable included in the

⁶ This analysis only includes the effects of the implementation of the proposed 2% sales tax on services. It does not include the effects of other tax changes included in the governor's proposal or the elimination of the Single Business Tax..

⁷ State of Michigan, Office of the State Budget, "Fiscal Year 2008 Executive Budget: Governor's Letter, Overview, Tax Restructuring Proposal, and Department Detail"; available at <http://www.michigan.gov/budget/0,1607,7-157--134602--00.html>; Internet; accessed 1 March 2007.

model, where the quantity supplied or demanded of each variable depends on the price of each variable. Tax policy changes are shown to affect economic activity through their effects on the prices of outputs and of the factors of production (principally, labor and capital) that enter into those outputs. A typical run of the model will answer questions such as, “How will a change in the top state personal income tax rate affect employment in the state?” The models have been used successfully by policymakers, research institutes and tax policy researchers.

Using the models, we simulated a sales tax change equivalent to an increase of 5% in total sales tax revenue – an amount large enough to elicit a robust response to the economic variables – for six states (Alabama, Mississippi, New York, Pennsylvania, South Carolina and Virginia). The results were used to estimate the average sales tax “elasticity” (the percentage change in a variable caused by a 1% change in the sales tax) for each economic variable. We also projected the average share of the static revenue estimate that represents the dynamic revenue increase, incorporating the economic impact of the tax increase on the state economies.

We determined the percentage increase in sales tax revenue the proposal would produce for each fiscal year of interest. Applying this percentage to each of the elasticities, we estimated the actual percentage change in the economic variables. We then multiplied the percentage change to the forecast for each economic variable in each fiscal year to estimate the dynamic change. Finally, we applied the estimated revenue share to the projected revenue share to determine the amount of revenue the policy change would generate.



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