VIEWPOINT
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Michigan Service Tax Proves (Groucho) Marx Correct

By James M. Hohman

Summary

Lansing policymakers want to extend the sales tax to a number of services in order to resolve their ongoing, self-created overspending crisis. Yet the state already taxes a number of services, and already receives more money than would be expected, given its poor economy.

Main Text Word Count: 644

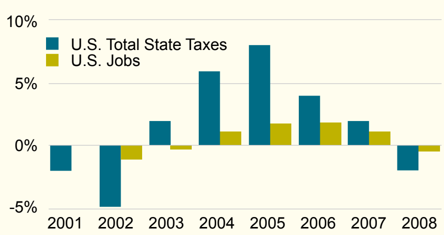
Michigan lawmakers are now mulling a "grand bargain" that would lower the sales tax from 6 percent to 5.5 percent while expanding it to services like dog grooming and accounting. The shifts would raise taxes by more than $900 million. The proposal brings to mind a saying often attributed to Groucho Marx, "Politics is the art of looking for trouble, finding it, misdiagnosing it, and then misapplying the wrong remedies."

The trouble that service-tax supporters see is easy to find: Without reform, Michigan expects to spend some $1.5 billion more than it receives in revenues next year — a fairly large sum, even in a $44.5 billion state budget. This is on top of the overspending crises the Legislature has created every year since 2001.

But the diagnosis of service-tax supporters is mistaken. They argue that Michigan's overspending is a problem of taxes, not expenditures. Contrary to their understanding, however, Michigan's tax system is putting more money into the state treasury than should be expected given Michigan's economy.

According to data from the U.S. Census Bureau, Michigan's overall tax revenue is down only 9 percent, while average state revenue in the rest of the country is down 13 percent. The state's gentler drop occurred even though Michigan has lost a greater share of its jobs than has any other state. Arguing that the system is broken when it's over-performing is comedic, albeit not as funny as Groucho.

U.S. Annual Tax Revenue and Job Growth



Source: Author's calculations based on data from the U.S. Census Bureau and the Bureau of Labor Statistics

Understanding the problem is critical to determining the correct remedy. Generally, state tax revenues multiply economic trends. After the 2001 recession, states lost an average of 1 percent of jobs and 5 percent of tax revenue. And during 2005, states gained 2 percent in jobs and 8 percent in revenue. Michigan is somewhat insulated from these trends. In the latest recession, states averaged a $14,300 decline in revenue for every job lost. Michigan, on the other hand, forwent only $6,700 per job. While it shouldn't be surprising that Michigan's revenue is down, it has shown surprising resiliency. But this also implies that either Michigan's economy needs to grow again or the state needs to enact structural reforms that bring down government costs and keep them low.

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Service-tax supporters even misdiagnose the supposed failures of Michigan's tax system. They argue it was written for a manufacturing economy, while most of Michigan is now employed in service industries.

But Michigan jobs have been heavily slanted toward services for a long time now — two decades ago, 75 percent of Michigan's jobs were in services and fueled surpluses in total state revenue for most of the 90s. It's 85 percent today. The pitch to modernize the state's tax system is based on some antiquated facts.

Expanding the sales tax to more services is the wrong remedy.

More importantly, service industries are already covered under other Michigan taxes. The personal income tax covers everyone, regardless of whether they are doctors or construction workers. Indeed, the Michigan business tax was specifically crafted to increase taxes on service industries and give major manufacturers a break.

Levying new taxes on services is an invitation to industry groups to lobby for exemptions. This is not conjecture, but an observation from other states' experience. Over the past four years, for instance, Maine legislators have labored to levy a sales tax on services as part of a "revenue-neutral" tax package. While the original formulations covered a broad array of services, exemptions piled up as the proposal was modified. When the resulting "reform" left the governor's desk, everything from lawyer bills to greens fees and ski lift tickets were exempt, prompting a statewide tax revolt.

Expanding the sales tax to more services is the wrong remedy. Michigan's tax system is showing resilience under trying circumstances. The better way to grow tax revenues is to grow the economy, which means reforming Michigan's labor laws, reducing the state's regulatory barriers and lowering Michigan's tax burdens — not shifting them. Reforms like these would prevent Lansing from devolving into a Marx Brothers farce.

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