

## **PUBLIC POLICY ADVISOR**

### **Cashing in on a Service Economy: Expanding the Sales Tax**

by Robert Kleine  
Vice President and Senior Economist

*Michigan's budget problems have generated legislative interest in new revenue sources. One of the largest potential sources of revenue is the extension of the sales tax to services not currently taxed. This paper discusses the advantages and disadvantages of taxing services, reviews the experience in other states, and provides estimates of the amount of revenue that could be raised in Michigan by taxing various categories of services.*

#### **INTRODUCTION**

The sales tax is the largest revenue source for state governments, producing almost one-third of all state revenues; a large number of local governments use it as well. The tax has several major advantages: It is productive, generating large amounts of revenue at low rates; it is relatively stable, rarely declining; and it is less unpopular with taxpayers than income or property taxes. The tax, however, also has important weaknesses: It is regressive, imposing a higher proportional burden on poor households than on rich households; it can distort purchasing, manufacturing, or other economic decisions by encouraging greater consumption of nontaxed items; and it can be difficult to administer, particularly when specific goods and services are exempted. Of all the weaknesses of the sales tax, the failure to tax services may be the most serious, as is discussed below. The exemption of services has its roots in the Depression, when the first state sales taxes were adopted. The states were wary in early enactments of taxing labor when so many were out of work; few governors or legislators wanted to be accused of burdening laborers with more taxes.

#### **BACKGROUND**

The tax on the retail sales of tangible property is classified as a consumption tax and is designed to reach the consumption of income-earning households. Since the purchase of consumer services is simply another form of consumption, to be fair, a consumption tax should apply equally to goods and services purchased by households.

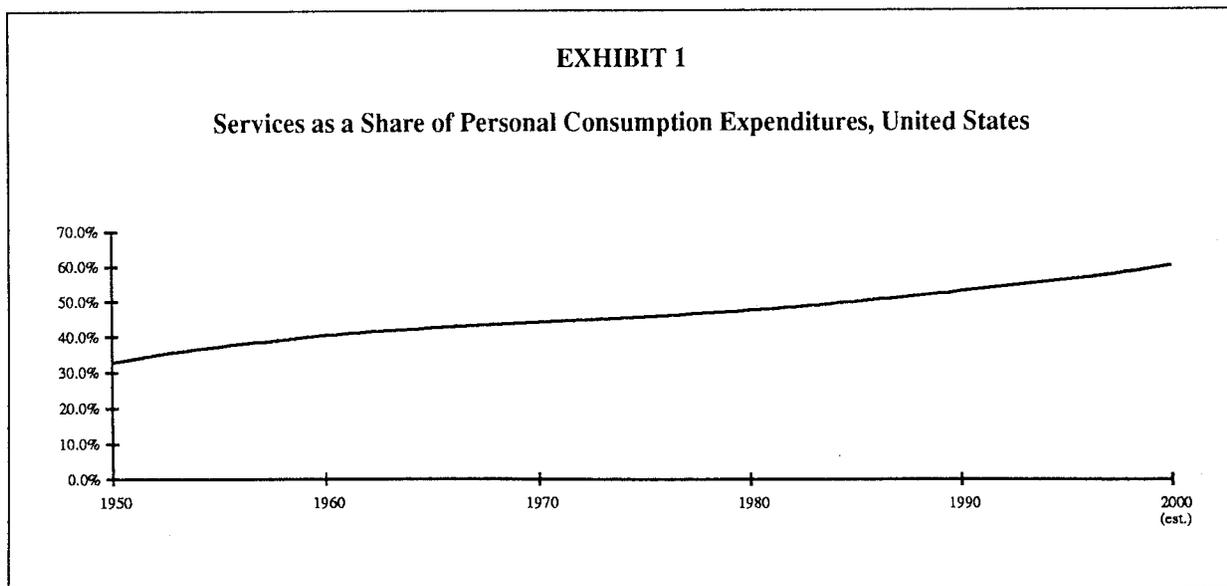
Forty-five states levy a sales tax, and all of them tax most tangible personal property; there is wide variation, however, in the taxation of services. The list below categorizes various types of goods and services. Items are listed roughly in order of use and of connection with tangible property, beginning with selected tangible property, moving to services connected with tangible or real property, and ending with professional services. Not coincidentally, this list is also roughly in order of frequency of taxation by state and local governments. (Michigan taxes few services below category #6.)

1. Tangible personal property other than food and prescription drugs
2. Food and prescription drugs
3. Services delivered with tangible property, such as photofinishing, printing, photocopying, custom fabrication on customer-owned property, custom computer programming, and funeral services
4. Services performed on tangible property, such as repair and installation, automobile towing, parking, and storage
5. Nonresidential utility service

6. Residential utility service, including inter- and intrastate telephone
7. Cable TV services
8. Amusements and admissions
9. Transportation services, including taxis, bus and train, limousine and charter air flight service
10. Construction of real property
11. Repair and remodeling of real property
12. Services performed on real property, including pest control, swimming pool cleaning, landscaping, and lawn care
13. Personal services, including barber and beauty shops, shoe repair, diaper service, tuxedo rental, laundry and dry cleaning
14. Business services, including security services, employment agencies
15. Advertising, public relations, and marketing
16. Professional services

A major concern with the exemption of many of the services listed above is that a major source of potential revenue growth is being ignored by state and local governments at a time when they are struggling to balance their budgets.

The United States and Michigan economies are becoming increasingly service oriented. Services were 40.5 percent of national consumption expenditures in 1965; they were 48 percent in 1980. By the first quarter of 1992 services accounted for 55.4 percent of every dollar spent on personal consumption. By 2000 services are expected to account for 61 percent of all personal consumption (see Exhibit 1). In Michigan services increased from 13.6 percent of employment in 1970 to 24 percent in 1991. Because of this, sales tax collections as a percentage of personal income declined from 1.95 percent in 1977 to 1.79 percent in 1991. Without this decline an additional \$275 million would have been collected in 1991.



States that do not tax the consumption of services may soon find it difficult to fund the public services demanded by the electorate. It is not surprising, then, that since 1985 at least twenty states have raised their sales tax rate and a number of states have broadened the base. In the last half of the 1980s, four states (Connecticut, Minnesota, Texas, and Florida) applied the sales tax to some services. Florida, however, repealed the expansion shortly after enactment in large part because the tax on advertising caused an uproar that was orchestrated by the media. In the last year seven states have extended the sales tax to cover selected services. Michigan has not raised the sale tax rate since 1961 and is not likely to do so in the near future

because the state constitution limits the rate to the current 4 percent. The only notable additions to the tax base in recent years have been computer software and some construction labor. Since 1991 there have been more exemptions from the base than additions.

Three types of taxes can be used to cover services: first, the traditional sales tax; second, a gross receipts or business and occupation tax, which is used by six states, and third, a destination-based, credit-type value-added tax covering all businesses. Michigan has a modified value-added tax, the single business tax (SBT), but many businesses are exempt because of generous credits and deductions. Furthermore, this tax replaced several other taxes, including the corporate income and franchise taxes and the personal property tax on inventories, and is viewed as a business tax rather than a consumption tax. Opponents of a sales tax on services will argue that the SBT already taxes services, but for the reasons just mentioned the SBT is far from a comprehensive tax on the consumption of services.

No large industrial state has been notably successful in taxing services much beyond utilities, hotels and motels, rentals, admissions, and repairs to tangible personal property. Florida's misadventure with the sales tax on services makes it more difficult for other states to act.

## TAX POLICY ISSUES

Extending the sales tax to services will improve its ability to meet government needs (adequacy) and to respond to changes in income (elasticity). It will also improve administration, reduce economic distortions, and improve the stability of the tax.

**Revenue Reliability and Stability:** The primary rationale for extending the sales tax to service transactions is tied to the shift in economic activity from the production of tangible goods to the "production" of services, as explained above. This continuing shift has raised concerns about the long-term vitality of a sales tax as a source of revenue when it is levied primarily on tangible property. A tax base that is more responsive to economic growth will provide the revenue needed to meet the increasing demand for public services and reduce the pressure to raise the rate or further expand the base of the tax.

**Economic Distortions:** Extending the sales tax to services also will reduce economic distortions. Taxing sales of tangible property raises the after-tax price of the good relative to the price of a nontaxed competing service. This encourages more consumption of the nontaxed service, which distorts decisions made by individuals and businesses, resulting in an inefficient allocation of resources.

There is, however, at least one instance in which extending the sales tax to services can cause distortions. Taxation of business services can introduce a potential distortion by encouraging more vertical integration by businesses. Since services provided by employees in-house would not be taxable, there would be an incentive for firms to perform services in-house that could be provided more efficiently by others. In this situation, smaller businesses that must procure services from other providers may be put at a competitive disadvantage, since their purchase of these services is taxable. The higher the tax rate, the greater the distortion, which argues for broadening the base and keeping the rate as low as possible.

**Administration:** To the extent that a sales tax on services removes distinctions among taxable activities, administration is improved. Removing such distinctions might prevent inconsistent legislative or judicial interpretations of sales tax statutes. For example, in Massachusetts, small marshmallows sold in salads are taxable, but large marshmallows are exempt; pet grooming in Wisconsin is considered a taxable repair and maintenance expense applied to tangible personal property; and in another state, a mailing list delivered on gummed labels is taxable but one delivered on paper is exempt. Taxing many services removes illogical and arbitrary distinctions between taxable property and nontaxable services. Ideally, there should be no distinctions between taxation of goods and of services.

Due to the increase in the number of businesses filing sales tax returns, taxation of services will result in some additional administrative costs. The size of this increase will depend on how many services are covered.

For example, extending the tax to auto repair services would not increase the number of returns, because these businesses already pay the sales tax on the parts used in repair. A sales tax on professional and business services, however, would significantly increase the number of tax returns.

**Tax Equity:** Proponents of taxing services generally argue that it will improve the fairness of the tax system. Horizontal equity (equal treatment of similarly situated taxpayers) would improve because, for example, the repair and the purchase of an item would be treated similarly. Since consumption would be taxed more broadly, differences in consumption patterns between goods and services would not result in differences in tax burdens. Vertical equity (unequal treatment of taxpayers at different income levels) would improve because higher income persons purchase more services, particularly professional services. The taxation of some services, such as labor and repair services and utility services, however, would be regressive. (See Exhibit 2.) Unless the sales tax is extended to cover all services there likely would be only a marginal improvement in the vertical equity of the sales tax.

## EXHIBIT 2

### Selected Consumer Expenditures as a Percentage of Income, 1990

Category	Income Level					All Income Levels
	Lowest 20 Percent	Second 20 Percent	Third 20 Percent	Fourth 20 Percent	Highest 20 Percent	
Utilities, fuels, and public services	21.5%	11.0%	7.5%	5.4%	3.5%	5.9%
Public transportation	2.1	1.0	1.0	0.8	1.0	0.9
Apparel and services	11.8	6.8	5.4	5.1	4.4	5.5
Health care	18.0	10.1	5.8	4.1	2.7	4.6
Entertainment	9.8	4.9	4.6	4.7	4.0	4.5
Personal care services	3.2	1.7	1.4	1.2	0.9	1.1
Education	6.2	1.3	1.0	0.8	1.2	1.3

SOURCE: U.S. Department of Labor, *Consumer Expenditures in 1990*, Washington, D.C.: November 22, 1991.

Two problems with the extension of the sales tax to services—tax pyramiding and purchases from out-of-state providers—must be addressed.

**Tax Pyramiding:** Application of the sales tax to business services raises the issue of pyramiding (multiple taxation of items at several stages of production and distribution) and the question of whether the traditional exemption method (exemption of inputs to production, such as plastic purchased for use in producing automobiles) can work with services. Most states attempt to minimize pyramiding of tangible personal property by exempting goods consumed in the production of or incorporated directly into a product that is subsequently sold at retail. They also exempt wholesale transactions or “sales for resale” by firms not classified as wholesalers. Taxation of utility services provides an example of how some states address pyramiding: While 38 states tax business use of fuels, 15, including Michigan, exempt fuel used in production if it is separately metered or measured.

**Purchases from Out-of-state Providers:** One of the most difficult sales tax problems is the imposition of the tax on services consumed in state but purchased from an out-of-state-provider. Most states, including Michigan, impose a “use” tax (like the sales tax, but generally imposed on intangible items such as rentals and telephone calls) on this activity. If a state such as Michigan does not impose the tax but one is imposed by other states on Michigan businesses doing business in those states, in-state businesses will be at a disadvantage in competing for commerce outside the state. They will also be at a disadvantage with an out-of-state provider who may not be required to tax sales to in-state customers. This is a particular problem

with a sales tax on services, as a use tax is more difficult to administer because there is nothing tangible to which to attach the tax and it is not easy to determine where the service is consumed. Some services, such as legal and accounting, may be used in several states, making it difficult to determine which state has jurisdiction and how much of the activity is subject to taxation. Most states have not attempted to impose a use tax on services, and those that have tried have generally been unsuccessful.

### SURVEY OF TAX PRACTICES IN OTHER STATES

One of the earliest classification schemes for state taxation of services was developed by John Due. His scheme ranks the states based on the level of taxation of services other than utilities, admissions, and transient accommodations (see Exhibit 3). The critical test in this ranking system is labor charge on repairs. Any state that taxes the labor on repairs to tangible property is given a rank of 1, 2, or 3, indicating the extent of taxation. States that do not generally tax repair labor are ranked a 4 or 5 (or zero, indicating no taxation). Although this rating system is adequate for some purposes, many state officials want a system that is more comprehensive and draws finer distinctions. Such a system has been available since 1990.

#### EXHIBIT 3

##### Sales Tax Treatment of Services Other Than Utilities, Admissions, and Transient Accommodations, 1988

General Taxation of Services 1	Broad 2	Substantial 3	Narrow 4	No Additional Services 5	No State Sales Taxation of Services 0
Hawaii	Iowa	Arkansas	Arizona	Alabama	Alaska
New Mexico	Washington	District of Columbia	Connecticut	California	Delaware
South Dakota	West Virginia	Florida	Minnesota	Colorado	Montana
		Kansas	North Carolina	Georgia	New Hampshire
		Louisiana	South Carolina	Idaho	Oregon
		Mississippi		Illinois	
		New Jersey		Indiana	
		New York		Kentucky	
		Ohio		Maine	
		Pennsylvania		Maryland	
		Tennessee		Massachusetts	
		Texas		<b>Michigan</b>	
		Utah		Missouri	
		Wisconsin		Nebraska	
		Wyoming		Nevada	
				North Dakota	
				Oklahoma	
				Rhode Island	
				Vermont	
				Virginia	

SOURCE: Federation of Tax Administrators, *Sales Taxation of Services*, Washington, D.C.: October 1990.

In May 1990 the Federation of Tax Administrators conducted a survey to catalog state practices (as of July 1, 1990) in the taxation of more than 160 service-related transactions under the general sales tax or some other excise or gross receipts tax. Exhibit 4 summarizes the results of this survey. Since 1990 there have been some changes to the list; the most significant is Massachusetts, which extended taxation to certain amusement, telecommunications, and business services.

## EXHIBIT 4

## State Rankings

Rank	State	Points	Rank	State	Points	Rank	State	Points
1	Hawaii	154	18	Florida	35	35	Kentucky	23
1	New Mexico	154	19	District of Columbia	52	35	Maine	23
3	Washington	151	20	Louisiana	48	37	Vermont	19
4	Delaware	147	21	Arkansas	47	37	North Dakota	19
5	South Dakota	131	21	Utah	47	39	Michigan	18
6	West Virginia	111	23	Nebraska	40	40	Indiana	17
7	Iowa	83	24	Pennsylvania	37	41	South Carolina	16
8	Texas	76	25	New Jersey	35	42	Oregon	15
9	Connecticut	75	26	Ohio	34	42	Illinois	15
10	Mississippi	67	27	Idaho	33	42	Virginia	15
11	Wisconsin	66	29	Oklahoma	32	42	California	15
11	Tennessee	66	29	Alabama	31	46	Montana	14
13	Kansas	64	29	Georgia	31	47	Nevada	12
14	Minnesota	60	31	North Carolina	26	47	Colorado	12
15	New York	58	32	Maryland	25	49	New Hampshire	11
16	Wyoming	56	33	Rhode Island	24	50	Massachusetts	4
17	Arizona	54	33	Missouri	24	51	Alaska	2

SOURCE: U.S. Department of Labor, *Consumer Expenditures in 1990*, Washington, D.C.: November 22, 1991.

The states demonstrate great diversity in their taxation of services. Hawaii, New Mexico, and South Dakota have general sales tax systems with broadly defined bases that cover most of the enumerated services. Of the 160 services covered in the survey, Hawaii and New Mexico tax 154, while South Dakota taxes 131 different services (see Exhibit 4). Michigan taxes only 18 categories, ranking 35th among the fifty states. The only major category in which Michigan taxes a significant number of the defined services is in utilities. In 1991 several states, including Connecticut, Florida, Massachusetts, Minnesota, New York, Ohio, and Pennsylvania, extended their sales tax to selected services. Ohio, for example, extended the sales tax to detective and protection agencies, lawn care/landscaping services, extended warranties, maintenance contracts, 900 numbers, and cable TV. Tennessee recently expanded the sales tax to cover health services and Iowa began taxing consulting, dating, taxidermy, and swimming pool services. A summary of the tax practices of the fifty states is included below, according to major category.

**Admissions and Amusements:** These are the most widely taxed categories of services. More than half the states tax 10 or more of the 14 defined services; however, nine, including Michigan, do not tax any service in this category except film and videotape rental. Cable TV services are taxed in 22 states. Admissions to professional sporting events are taxed in 35 states, while college events are taxed in only 27.

**Computer Services:** Except for canned or packaged software these services are not widely taxed. Only 16 states, including Michigan, tax custom software, while 15 states tax other types of computer services.

**Professional Services:** This category includes accountants, attorneys, dentists, engineers, land surveyors, medical labs, nursing (out-of-hospital), and physicians. Only eight states tax any of these services and only four tax all of them—Hawaii and New Mexico levy a general sales tax and Delaware and Washington levy a business gross receipts tax.

**Personal Services:** Twenty different services are included in this category. Tuxedo rental is the most widely taxed (33 states); barber and beauty are the least taxed (6 states). Michigan taxes tuxedo rental, 50 percent of the charges for funeral services, and 35 percent of charges for shoe repair. Three states tax all twenty services, 10 states tax at least half, and 27 states tax two or fewer of these services. As might be expected, services involving tangible personal property, such as garment alteration, shoe repair, and laundry, are the most widely taxed.

**Business Services:** Thirty-four services are included in this category. The most widely taxed are photo finishing (42 states) and printing and photocopying (39 states). These are the only services in this category taxed by Michigan. Only five states tax most of these services; 34 states tax four or fewer.

**Repairs, Custom Fabrication, and Installation:** This category, along with admissions and utilities, is most frequently taxed, mainly because of the close relationship to tangible personal property, the traditional focus of the sales tax. Michigan, however, taxes only 2 of the 19 services in this category, custom fabrication labor and repair labor. States that do not tax this category usually do not tax many services. Only seven states do not tax labor while taxing more than 26 of the services covered in the survey.

**Utilities:** This category includes 14 different services, including intra- and interstate telecommunications, electricity, water and natural gas, other fuels, and sewer services. These services are widely taxed by most states, including Michigan. Forty-two states tax intrastate telecommunication (only 18 tax interstate telephone), 38 states tax electricity, 22 states tax water, and 38 states tax fuels. Michigan taxes all of these services except water.

**Other Services:** The survey included a number of other services—agricultural; industrial mining; transportation and storage; finance, insurance, and real estate; automotive; and rental and leasing. These services generally are not taxed; the major exception is rental and leasing services, the only category on which Michigan imposes a sales (or use) tax.

## ESTIMATES OF POTENTIAL REVENUE

The most recent data on revenues from service firms by state are from the 1987 census. These data were updated to 1991 by increasing each category by the 1987–90 growth rate in personal income for each major subgroup in services and the 1991 growth in total service income (detail by subgroup is not yet available). For example, all the categories under personal services were increased by the growth rate in personal income generated by firms classified under the personal services category for 1987–90 and by the 1991 growth rate for all firms in the services category. These estimates are presented in Exhibit 5. The estimated revenue for several categories is reduced because the state already taxes a portion of the sales of these businesses. For example, 35 percent of sales by funeral parlors are subject to the sales (or use) tax.

As shown in Exhibit 5, a 4-percent sales tax would generate about \$1.2 billion in revenue. It is unlikely, however, that the governor and the legislature would agree to tax all services. The most likely candidates for taxation are amusements, auto-related services, miscellaneous repair, business, and personal services. Taxation of these categories would raise an estimated \$525 million in revenue.

## CONCLUSION

There are three good reasons for extending the sales tax to cover most services. First, taxing some forms of consumption and not others is inequitable and is only justified if the exemption makes the sales tax less regressive, as in the case of the exemption for food and drugs. Second, services are the fastest growing sector of the economy; failure to tax this sector slows the growth in state revenue and increases pressure for tax increases and budget reductions. Third, many states are experiencing severe budget problems, and for many states this is the largest source of revenue that is available without raising tax rates. Even if additional revenue is not needed, the fairness of the sales tax could be improved by extending the tax to services and reducing the rate to maintain the same amount of revenue.

Clearly, Michigan needs additional revenue to improve the equity of school financing and to reduce pressure on the property tax, which is overutilized in this state. If the governor's "cut and cap" property tax plan is approved in November, there will be added pressure on the state budget and the legislature will almost certainly be forced to look for new revenue sources. In our view, a sales tax on services is the first place they should look.

### EXHIBIT 5

#### Estimated Revenue from Sales Tax on Services, Michigan, 1991 (dollars in thousands)

	1987 Receipts	Estimated 1991 Receipts	Estimated Sales Tax Revenue
<b>Personal Services</b>	\$1,126,971	\$1,548,458	\$61,938
Laundry, cleaning, and garment	453,633	623,292	24,932
Photographic studios	68,583	94,233	3,769
Beauty and barber shops	255,319	350,808	14,032
Shoe repair	7,204	9,898	396
Funeral	218,824	300,664	12,027
Tax return	35,537	48,828	1,953
Miscellaneous	87,871	120,735	4,829
<b>Business Services</b>	\$5,925,326	\$6,577,112	\$263,084
Advertising	639,750	710,123	28,405
Consumer credit agencies	107,809	119,668	4,787
Direct mail advertising	118,012	130,993	5,240
Photocopying and duplicating	68,261	75,770	3,031
Secretarial/court reporting	39,699	44,066	1,763
Commercial photography	262,456	291,326	11,653
Disinfecting/pest control	330,758	367,141	14,686
Building cleaning/maintenance	281,488	312,452	12,498
Medical equipment rental	58,889	65,367	2,615
Heavy construction rental	130,324	144,660	5,786
Other equipment rental/leasing	263,510	292,496	11,700
Employment agencies	90,934	100,937	4,037
Help supply	670,615	744,383	29,775
Computer programming	383,901	426,130	17,045
Prepackaged software	59,942	66,536	2,661
Computer-integrated system design	141,451	157,011	6,280
Data processing	470,628	522,397	20,896
Computer rental/leasing	129,877	144,163	5,767
Computer maintenance/repair	198,297	220,110	8,804
Other computer	53,345	59,213	2,369
Detective/protective agencies	248,839	276,211	11,048
Security systems	67,594	75,029	3,001
News syndicates	10,401	11,545	462
Photo-finishing labs	109,666	121,729	4,869
Sign painting	13,523	15,011	600
Interior design	27,542	30,572	1,223
Telephone answering	21,889	24,297	972
Packaging and labeling	174,111	193,263	7,731
Other business	751,815	834,515	33,381
<b>Automotive Services</b>	\$1,840,704	\$2,457,340	\$98,294
Auto rental & leasing	464,200	619,707	24,788
Parking	48,965	65,368	2,615
Repair shops	1,123,477	1,499,842	59,994
Car washes	97,338	129,946	5,198
Other auto	106,724	142,477	5,699

## EXHIBIT 5 continued

<b>Miscellaneous Repair Services</b>	\$788,597	\$1,089,052	\$43,562
Electrical	230,358	318,124	12,725
Watch/jewelry	5,514	7,615	305
Reupholstery/furniture	23,706	32,738	1,310
Welding	56,421	77,917	3,117
Other	472,598	652,658	26,106
<b>Amusement and Recreation Services</b>	\$1,421,995	\$2,300,788	\$92,032
Motion picture production	341,815	553,057	22,122
Motion picture theatres	137,242	222,058	8,882
Videotape rental	91,676	148,332	5,933
Theatrical producers	81,608	132,042	5,282
Bowling centers	182,283	294,934	11,797
Commercial sports	156,862	253,803	10,152
Physical fitness facilities	90,142	145,850	5,834
Public golf courses	86,955	140,693	5,628
Amusement parks	22,970	37,165	1,487
Membership sports/recreation clubs	116,854	189,070	7,563
Other	113,588	183,785	7,351
<b>Health Services</b>	\$5,774,579	\$7,737,936	\$309,517
Physicians	2,875,183	3,852,745	154,110
Dentists	1,071,311	1,435,557	57,422
Doctors of osteopathy	403,149	540,220	21,609
Nursing/personal care facilities	601,733	806,322	32,253
Hospitals	242,808	325,363	13,015
Medical/dental labs	307,925	412,620	16,505
Home health care	87,246	116,910	4,676
Miscellaneous	185,224	248,200	9,928
<b>Legal Services</b>	\$1,769,856	\$2,442,401	\$97,696
<b>Selected Educational Services</b>	\$127,149	\$178,899	\$7,156
Vocational schools	92,291	129,853	5,194
Other schools/education services	34,858	49,045	1,962
<b>Social Services</b>	\$219,157	\$350,213	\$14,009
Child day care	55,233	88,262	3,530
Residential care	110,227	176,143	7,046
Other	53,697	85,808	3,432
<b>Engineering, Accounting, Etc. Services</b>	\$3,748,258	\$6,791,843	\$271,674
Engineering, architecture, surveying	1,710,303	3,099,069	123,963
Accounting, auditing, bookkeeping	787,110	1,426,243	57,050
Research, development, testing	476,923	864,184	34,567
Management and public relations	773,922	1,402,347	56,094
<b>Other Services</b>	\$101,939	0	0
Subtotal	\$22,844,531	\$31,474,042	\$1,258,962
Less: Items currently taxed		1,726,995	69,080
<b>TOTAL</b>		\$29,747,047	\$1,189,882

Source: U.S. Department of Commerce, Bureau of the Census, 1987 Census of Services, Washington, D.C. Calculations by Public Sector Consultants, Inc.

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Robert J. Griffore, Ph.D.	John Porter, Ph.D.	Keith Wilson