Sales and Use Taxes

BACKGROUND

Article IX, section 8 of the Michigan Constitution provides for a sales tax on retailers of no more than 6 percent of their gross tangible sales of personal property; the constitution also requires that at least 73 percent of the revenue generated by the levy be dedicated to funding K–12 education. Any hike in the sales tax rate must be accomplished through a constitutional amendment.

The sales tax base consists of most final retail transactions of goods in the state. The major exceptions are

- prescription drugs;
- food for human consumption except that for immediate consumption (in other words, most food bought at a grocery store is exempt, but food bought at a restaurant is not);
- business purchases used for resale;
- most services;
- residential home heating fuel, which is taxed at only 4 percent; and
- purchases by government agencies and eligible nonprofit organizations.

Michigan also levies a use tax based on the privilege of using or storing certain property in the state; that is, goods bought outside the state but used in Michigan are exempt from the sales tax but subject to an identical 6 percent use tax. Use taxes were devised by states to offset the loss of sales tax revenue when goods are purchased out of state and also to remove the disadvantage to local businesses of competing with out-of-state firms. Some services, such as hotel room rentals and telephone service payments, also are subject to the use tax, and so are private used-car transactions.

In FY 1996–97 the state sales tax generated about $5.4 billion, while the use tax raised another $1.1 billion, for a total of $6.5 billion. Of the sales tax collections,

- 73 percent were deposited in the School Aid Fund, to be used for K–12 education;
- 24 percent went to local units of government, through revenue sharing; and
- 3 percent went to the state’s general and transportation funds.

GLOSSARY

Consumption tax 
A levy on consumer goods; sales and use taxes are consumption taxes.

Sales tax 
A flat percentage levy on an item’s selling price; in Michigan the sales tax applies only to most items sold at retail.

Use tax 
A levy on a good’s initial use (as opposed to one levied on its sale); in Michigan the use tax applies to items purchased outside of the state but used or stored in the state.
Of the use tax collections,

- 33 percent were deposited in the School Aid Fund, and
- 67 percent were deposited in the General Fund.

Exhibit 1 shows the changes in sales and use taxes (together called consumption taxes) for three representative years. In 1984 they generated $2.2 billion, more than 17 percent of total state revenue. By 1997 consumption-tax revenue had risen to $6.5 million, more than 22 percent of all state revenue. The reason for the increased collections, both in absolute terms and as a percentage of total revenue, is the 1994 increase in the rate from 4 percent to 6 percent. (In 1994 the school-finance reform package known as Proposal A raised the sales and use tax rate, the first such increase in more than 30 years; all new revenue from the increase is dedicated to K–12 education.)

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Sales and Use Tax Revenue (millions)</th>
<th>Percentage of Total State Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983–84</td>
<td>$2,242</td>
<td>17.3%</td>
</tr>
<tr>
<td>1990–91</td>
<td>3,146</td>
<td>18.9</td>
</tr>
<tr>
<td>1996–96</td>
<td>6,476</td>
<td>22.2</td>
</tr>
</tbody>
</table>

SOURCE: Michigan Department of Treasury.

Exhibit 2 presents 1984–97 actual and inflation-adjusted annual sales and use tax collection data. Actual tax collections rose each year, but after adjusting for inflation, consumption tax collections essentially were flat from 1986 to 1993.

All but five states levy a consumption tax; most in the 3–7 percent range. Unlike Michigan, many allow some local governments (usually counties or high-population cities) to levy a separate sales tax in addition to the state levy.

DISCUSSION

Consumption Tax Issues

Debate about consumption taxes in Michigan centers on three issues:

- Should the taxes be extended to services?
- Do consumption taxes disproportionately affect the poor?
- Should the state rely on a levy that taxpayers cannot deduct from their federal income tax liability?

First, the current consumption tax base is shrinking relative to the economy as a whole. These taxes historically have been levied on the sale or use of tangible goods. Most services—ranging from professional business services to dry cleaning—have remained exempt.
However, as the state has changed, the proportion of the economy subject to the taxes has diminished. For example, in 1950 only 21 percent of the U.S. economy was attributed to service industries (and, therefore, in large part exempt from consumption taxes), but by 1992 that percentage had risen to 53 percent (comparable data for Michigan are unavailable). This trend will continue, which means that in Michigan we are relying on a consumption tax base that is shrinking each year relative to the economy as a whole. If Michigan were to extend the consumption taxes to services (the fastest growing sector of the economy), estimates are that state revenue would be boosted by more than $2 billion annually.

Second, Michigan’s sales tax exemptions for most food and medicine are intended to ease the tax’s hardship on lower-income families, but some observers believe the hardship should be further reduced and the revenue loss offset by an increase in the state income tax. In the past, most analysts thought consumption taxes to be slightly regressive, meaning that their burden (relative to available income) is reduced as one moves up the income scale. In the past few years, however, many analysts have shifted from judging the fairness of a tax by its burden on annual income to its burden over an individual’s lifetime. Using the latter measure, many analysts conclude that the relative burden of consumption taxes is roughly equal for all income groups.

Third, state consumption tax payments no longer may be deducted against one’s federal income tax liability. Until the mid-1980s all state and local tax payments could be deducted from federal taxable income; now only state income and property taxes are deductible. Some analysts argue that this change has raised the total burden of the consumption taxes compared to other state levies. For example, if Ms. X itemizes on her federal return, the after-tax cost of $100 in local property taxes is $100 minus her marginal federal tax rate: on average, the after-tax cost is about $75. But since consumption taxes may not be itemized, the after-tax cost of $100 in sales/use taxes is $100.

While not disputing this point, some analysts downplay federal deductibility’s importance. They point out that deductibility is irrelevant for the majority of taxpayers, since most do not itemize on their federal return. In a typical year, only one-third of Michigan taxpayers itemize at the federal level, and those who do tend to be at the higher end of the income scale.

Some analysts point out that consumption taxes have certain advantages.

- Some portion of the sales tax burden may be exported to non-Michigan residents who travel into this state. An estimated 5–15 percent of all Michigan state consumption tax revenue comes from taxes on sales to nonresidents.
- Some point out that the public finds consumption taxes more palatable than other levies because some purchases are made at the consumer’s discretion. Families may delay or accelerate purchase of many big-ticket items that are subject to the sales tax, depending on their current circumstances. In contrast, the state income tax is paid when income is accrued, thus there is no way, short of not working, to delay the tax liability.
- Some believe an important criterion of a good state tax system is “balance”—avoiding too much reliance on any one revenue source. In Michigan, since the 1994 sales/use tax increase, the state annually generates roughly $6 billion in consumption taxes and $6 billion in income taxes.

**Federal Proposals**

In recent years, some policymakers have proposed replacing the federal income tax with a national sales tax. Proponents of the change argue that our society should be encouraging savings and discouraging consumption. As an incentive, these policymakers argue that we should reduce the federal tax on income and tax consumption instead.

U.S. Sen. Richard Lugar has proposed levying a national sales tax of 17 percent on the majority of retail sales in the United States and eliminating the
income tax. As first proposed, the Lugar sales tax would apply to most service transactions, including housing rental, food, and medical care. The 17 percent rate would be more than 2½ times the highest rate currently levied by any state.

Although adopting a national sales tax seems remote, its passage would have important implications for Michigan’s consumption taxes. A high federal rate in combination with Michigan’s 6 percent would invite significant tax evasion. As the sales/use tax rate climbs over 10 percent, it is believed that the incentive to illegally avoid the tax through unrecorded transactions becomes great. If the federal sales tax led to a reduction in recorded sales, Michigan’s revenue would decline.

See also Business Taxes; K–12 Funding.

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