SENATE FISCAL AGENCY
MEMORANDUM

DATE: March 3, 2010

TO: Members of the Senate

FROM: Eric Scorsone, Senior Economist
David Zin, Economist

RE: Governor's FY 2010-11 Proposed Tax Changes

Proposal

In her FY 2010-2011 budget, Governor Granholm has proposed several important changes to the Michigan tax system. The largest changes are targeted at the sales and use tax and the Michigan Business Tax (MBT). Other smaller changes are targeted at the individual income tax and a car rental fee. The proposed changes are to:

Sales and Use Tax Changes:
- Expand sales tax to many service sector categories;
- Reduce sales and use tax rate to 5.5%.

Michigan Business Tax Changes:
- Phase out of the Michigan Business Tax surcharge in 2011 and 2012;
- Cut Gross Receipts Tax in 2012 and 2013.

Income Tax Changes:
- Create Michigan Promise Income Tax Credit;
- Create Angel and Venture Capital Investor Tax Credit.

In Table 1, the total proposal is depicted as proposed by Governor Granholm. This table is focused on FY 2011 only. However, as depicted later, these changes have longer run implications as well.

The net effect of these tax changes varies over time as shown in Table 2. Beginning in FY 2011, the net effect would be net revenue of 564.2 million. The vast majority of these funds, $554.2 million, will be made available to the School Aid Fund. The rest of the funds, $13.0 million, will be made available to a restricted fund for the Pure Michigan program.

The net revenue impact of the plan begins to decrease starting in FY 2011-12 and declines to nearly zero by FY 2013-14. This occurs because the increase in the base of the sales and use tax that generates new revenue is offset by the elimination of the Michigan Business Tax surcharge and the lowering of the gross receipts tax rate over three years. By FY 2013-14, the net revenue effect of all of these changes is very close to zero.

201 N. Washington Square • Suite 800 - The Victor Center • Lansing, Michigan
Telephone: (517) 373-2768 • TDD: (517) 373-0543 • Fax: (517) 373-1986

Table 1

Governor's Proposed Tax and Revenue Increases: FY 2010-11 (Millions of Dollars)				
	State Government Fiscal Impact			
Proposed Tax/Revenue Increase	GF/GP	School Aid Fund	Other	Total
Sales & Use Taxes:				
Extend Sales Tax to Services @ 5.5% 12/1/10	$0.0	$1,261.8	$0.0	$1,261.8
Reduce Sales Tax Rate to 5.5% 12/1/10	$0.0	($422.1)	$0.0	($422.1)
Reduce Use Tax Rate to 5.5% 12/1/10	$0.0	($80.6)	$0.0	($80.6)
Reduce HMO Use Tax Rate to 5.5% 12/1/10	$0.0	($25.3)	$0.0	($25.3)
Collection allowance for Service Tax	$0.0	($5.2)	$0.0	($5.2)
Treasury Administrative Cost	$0.0	($3.6)	$0.0	($3.6)
Subtotal Sales & Use Taxes	**$0.0**	**$725.0**	**$0.0**	**$725.0**
Sales Tax	**$0.0**	**$839.7**	**$0.0**	**$830.9**
Use Tax	**$0.0**	**($105.9)**	**$0.0**	**($105.9)**
Michigan Business Tax:				
Surcharge Phase Out in 2011 and 2012	$0.0	($170.8)	$0.0	($170.8)
Gross Receipts Tax Rate Cut in 2012 and 2013	$0.0	$0.0	$0.0	$0.0
Subtotal Michigan Business Tax	**$0.0**	**($170.8)**	**$0.0**	**($170.8)**
Income Tax:				
Create Michigan Promise Income Tax Credit	($6.8)	$0.0	$0.0	($6.8)
Eliminate College Tuition and Fees Tax Credit	$8.8	$0.0	$0.0	$8.8
Angel and Venture Capital Investor Tax Credit	($5.0)	$0.0	$0.0	($5.0)
Subtotal Income Tax	**($3.0)**	**$0.0**	**$0.0**	**($3.0)**
Other Tax & Revenue Increases:				
Create a Car Rental Fee	$0.0	$0.0	$13.0	$13.0
Subtotal Other Tax and Revenue Increases	$0.0	$0.0	$13.0	$13.0
Total Proposed Tax Increases	**($5.0)**	**$554.2**	**$13.0**	**$562.2**

Table 2

Summary of Governor's Sales, Use, and Michigan Business Tax Proposals (Millions of Dollars)				
	FY 2010-11	**FY 2011-12**	**FY 2012-13**	**FY 2013-14**
MBT Changes:				
Surcharge Phase Out n 2011 and 2012	$(170.8)	$(455.8)	$(572.4)	$(583.9)
Gross Receipts Tax Rate Cut in 2012 & 2013	0.0	(120.6)	(316.2)	(395.0)
Subtotal MBT Cuts	**$(170.8)**	**$(576.4)**	**$(888.6)**	**$(978.9)**
Sales and Use Tax Changes:				
Reduce Sales Tax Rate to 5.5% 12/1/10	$(422.1)	$(521.7)	$(537.4)	$(553.5)
Reduce Use Tax Rate to 5.5% 12/1/10	(80.6)	(99.6)	(102.6)	(105.6)
Reduce HMO Use Tax Rate to 5.5% 12/1/10	(25.3)	(31.8)	(33.4)	(35.1)
Extend Sales Tax to Services @ 5.5% 12/1/10	1,261.8	1,567.2	1,622.0	1,695.0
Collection Allowance for Service Tax	(5.2)	(6.4)	(6.6)	(6.9)
Subtotal Sales and Use Tax Changes	**$728.6**	**$907.7**	**$942.0**	**$993.9**
Administrative Costs	**(3.6)**	**(3.9)**	**(4.8)**	**(4.8)**
Net Revenue Change	**$554.2**	**$327.4**	**$48.6**	**$10.2**

In Table 3, the distribution of the tax cuts between individuals and business is depicted. The Governor's tax proposal is based on a major tax increase to individuals via the expansion of the sales and use tax base with some offset due to the rate reduction and a decrease to businesses via the reduction in the Michigan Business Tax.

Table 3

Individual Versus Business Impact
Governor's Sales, Use, and Michigan Business Tax proposal
(Millions of Dollars)

	FY 2010-11	FY 2011-12	FY 2012-13	FY 2013-14
Individual:				
Extend Sales Tax to Services @ 5.5%	$1,179.8	$1,465.3	$1,516.6	$1,584.8
Reduce Sales Tax Rate to 5.5%	($295.5)	($365.2)	($376.2)	($387.5)
Reduce Use Tax Rate to 5.5%	($57.6)	($71.2)	($73.4)	($75.5)
Subtotal Individual	**$826.7**	**$1,028.9**	**$1,067.0**	**$1,121.9**
Business:				
Surcharge Phase Out	($170.8)	($455.8)	($572.4)	($583.9)
Gross Receipts Tax Rate Cut	$0.0	($120.6)	($316.2)	($395.0)
Reduce HMO Use Tax Rate	($25.3)	($31.8)	($33.4)	($35.1)
Extend Sales Tax to Services @ 5.5%	$82.0	$101.9	$105.4	$110.2
Reduce Sales Tax Rate to 5.5%	($126.6)	($156.5)	($161.2)	($166.1)
Reduce Use Tax Rate to 5.5%	($23.0)	($28.4)	($29.2)	($30.1)
Collection Allowance for Service Tax	($5.2)	($6.4)	($6.6)	($6.9)
Subtotal Business	**$(268.9)**	**$(697.6)**	**$(1,013.6)**	**$(1,106.9)**
Government				
Treasury Administration	**$(3.6)**	**$(3.9)**	**$(4.8)**	**$(4.8)**
Net Revenue Change	**$554.2**	**$327.4**	**$48.6**	**$10.2**

Changes to the Sales and Use Tax

The next section describes in detail the proposed changes in the Michigan sales and use tax. The changes are designed to tax consumer service consumption and avoid as much as possible, taxing business to business services. The basic principle is that a business-to-business transaction should be exempt from taxation as long as it is "principle" to the business operation. Therefore, certain business-to-business transactions such as landscaping, security services, extermination, and other nonprincipal business-to-business services are taxed under these changes. The rationale for avoiding business-to-business transactions is the problem of tax pyramiding. Tax pyramiding occurs when a tax at one level in the chain of production is the passed on to another level in the production chain leading to distortions in the economy.

The following tables detail the service categories and revenue raised from each category. Table 4 depicts the revenue raised across all service sector categories. Table 5 depicts, as a component of Table 4, the amount of revenue raised due to nonprincipal business-to-business transactions. The revenue figures in Table 5 are included in Table 4.

Table 4

Revenue Generation from Various Service Sectors		
Service	**FY 2010-11[a)]**	**FY 2011-12**
Live entertainment - performance/sports	$71.5	$88.8
Museums/zoos/parks	$10.0	$12.4
Amusement parks & arcades	$3.4	$4.2
Gambling industries	$1.2	$1.5
Golf courses/country clubs	$30.3	$37.6
Skiing facilities	$1.8	$2.2
Marinas	$9.0	$11.2
Fitness & sports centers	$20.6	$25.5
Bowling centers	$9.0	$11.2
Other recreation & amusement	$13.1	$16.3
Movie tickets	$14.2	$17.6
Cable/satellite TV	$115.5	$143.4
Scenic transportation	$1.0	$1.3
Repair & maintenance	$191.8	$238.2
Personal care services	$63.3	$78.6
Accommodations - parks/camping	$13.5	$16.7
Travel agencies	$13.4	$16.6
Tour operators/other travel services	$9.4	$11.7
Other personal services (1)	$71.3	$88.5
Miniwarehouses/self storage	$4.0	$4.9
Dry-cleaning & laundry services	$32.1	$39.9
Landscaping	$47.5	$59.0
Carpet/upholstery cleaning	$4.1	$5.1
Other services to buildings/dwellings (2)	$10.7	$13.3
Transit & ground transportation	$26.7	$33.2
Support activities for road transportation (3)	$8.3	$10.4
Exterminating/pest control services	$5.1	$6.4
Janitorial services	$5.5	$6.9
Death care services	$13.4	$16.6
Collection agencies	$0.6	$0.8
Private investigation	$1.2	$1.5
Security systems services	$16.4	$20.4
Document preparation services	$0.4	$0.5
Business service centers	$6.1	$7.5
Packaging/labeling services	$0.6	$0.8
All other support services (4)	$0.7	$0.9
Waste collection	$38.1	$47.3
Waste treatment/disposal	$1.6	$1.9
Remediation/other waste services	$4.5	$5.6
Real estate agents/brokers - except property sales	$8.8	$10.9
Other real estate-related activities (5)	$19.6	$24.3
Legal services	$59.8	$74.3
Accounting services	$42.1	$52.3
Architectural	$11.1	$13.7
Specialized design	$7.3	$9.1

Revenue Generation from Various Service Sectors		
Service	**FY 2010-11[a)]**	**FY 2011-12**
Consulting	$17.8	$22.2
Advertising	$2.3	$2.8
Other professional/technical services (6)	$28.4	$35.3
Investment advice	$5.3	$6.6
Child care services	$57.3	$71.1
Information services/data processing	$20.6	$25.5
Water/sewerage	$45.3	$56.3
Other real estate property	$21.8	$27.1
Educational services	$23.4	$29.0
Net Impact	**$1,261.9**	**$1,567.2**
[a)] Tax effective 12/01/2010		

As Table 4 indicates, there is a wide range of revenue generation depending on the activity level of the service in the State. The biggest revenue generation categories are in areas such as:

- Repair and maintenance services ($191.8 million);
- Cable/satellite TV (143.4 million);
- Live entertainment ($88 million);
- Legal Services ($74.3 million);
- Water and sewer services ($56.5 million).

Table 5 identifies the business-to-business services that are estimated to be taxed under the proposal. Note again that these figures are included in Table 4 and are not in addition to the revenue reported in Table 4.

Table 5

Business to Business Services Taxed (Millions of Dollars)	
Service	**FY 2010-11**
Ground passenger transportation	$10.7
Cable/Satellite TV	$12.0
Travel services	$9.7
Security systems services	$7.7
Exterminating/pest control	$2.4
Landscaping	$23.7
Other services to buildings	$6.1
Waste collection	$23.2
Entertainment	$4.2
Dry cleaning/laundry	$13.5
Educational services	$28.1
Real estate agents/brokers other than property sales	$10.6
Total	**$151.9**
* Revenue figures only available for FY 2010-11.	

Total Revenue Impact

These changes are designed in the Governors proposal to only affect the School Aid Fund (SAF). This would have to be accomplished by changes in the earmarking process of these revenue sources.

As described in the next section. In total, $1.26 billion would be generated through these tax changes. Some sales and use tax revenue, a total of $536.8 million, would be lost due to the rate reduction from 6.0% to 5.5% and some administrative costs necessary to collect the tax. Therefore, the total revenue impact in year one (FY 2010-11) would be a net revenue increase of $725.0 million.

Earmarking of Sales and Use Taxes

Under current law, sales tax revenue is subject to substantial earmarking, with a fraction more than 100% of sales tax revenue earmarked under the right combination of appropriations. The earmarks are both constitutional and statutory in nature and generally apply to sales of tangible personal property, although the services currently subject to sales and/or use taxation are not treated differently from those of tangible personal property. Based on current law, sales tax revenue is subject to the following earmarks:

- 60% of the sales tax levied at a rate of 4% is constitutionally restricted to the School Aid Fund.
- 15% of the sales tax levied at a rate of not more than 4% is constitutionally designated for revenue sharing assistance to cities, villages, and townships.
- 21.3% of the sales tax levied at a rate of 4% is statutorily earmarked for revenue sharing assistance to counties, cities, villages, and townships.
- $9.0-$12.0 million of sales tax revenue is statutorily diverted to the Michigan Health Initiative Fund.
- 27.9% of the sales tax imposed at a rate of 4% on motor vehicle-related sales (fuel, vehicles, vehicle parts, etc.) is statutorily earmarked to the Comprehensive Transportation Fund.
- 100% of the sales tax collected at a rate of 2% (as a result of the constitutional changes made with the adoption of Proposal A in 1994) is constitutionally restricted to the School Aid Fund.

Use tax revenue is subject to different earmarking, with 100% of the revenue from the 4% rate going to the General Fund and 100% of the revenue from the 2% rate going to the School Aid Fund. Unlike the previous attempt to tax services by expanding the use tax, the Governor's proposal would tax services under the sales tax.

Legislation has yet to be introduced reflecting the Governor's proposal. However, directing the increased revenue to the School Aid Fund while not reducing revenue to the funds currently earmarked will require a variety of adjustments and new earmarks. The changes will need to address a variety of issues, including:

- The taxation of tangible personal property versus the taxation of services.
- Issues where the Constitution specifies the earmark to be set at a rate of 4%, rather than at a rate that will fall if the tax rate is lowered under the proposal.
- How existing statutory earmarks to the Comprehensive Transportation Fund, the Michigan Health Initiative Fund, and revenue sharing will be affected by the reduced rate combined with the expanded range of taxed economic activities.
- Essentially converting a portion of what is currently constitutional revenue sharing revenue to a new statutory earmark.

As the legislation is introduced and more details are available, the SFA will provide additional information regarding how any earmarks in the proposed tax revenue will be implemented.

c: Gary S. Olson, Director
Ellen Jeffries, Deputy Director

/kjh:es\mem030210