Taxes on Consumers

BACKGROUND

Sales and Use Taxes

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 (i.e., 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 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 use or storage of 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 2000–01 the state sales tax generated about $6.4 billion, while the use tax raised another $1.3 billion for a total of $7.7 billion. Of sales tax collections,

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

Of use tax collections,

- 33 percent are deposited in the School Aid Fund; and
- 67 percent are deposited in the General Fund.

Exhibit 1 shows the changes in sales and use tax revenue for three representative years. In 1984 they generated $2.2 billion, more than 17 percent of total state revenue. By 1997 revenue had risen to $6.5 million and the percentage to 22 percent. The reason for the

GLOSSARY

Base
In taxation, the dollar value on which a tax is levied.

Consumption tax
A levy on consumer goods.

Intangible property
A financial asset having no intrinsic value but representing value—e.g., securities, accounts receivable, notes.

Nexus
The minimum physical presence or link to a state that would subject a business to a state's tax system and require the business to collect and remit taxes.

Remote sales
Usually, catalog and Internet purchases.

Sales tax
A flat percentage levy on an item's selling price: in Michigan, 6 percent.

Tangible property
Any property other than real estate or money that has physical substance and can be touched—e.g., furniture, cars, jewelry.

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 (1) items purchased out of state, and (2) items used or stored in the state; it also applies to private used-car transactions.

EXHIBIT 1. Michigan Sales and Use Tax Collections, Selected Fiscal Years

Fiscal Year	*Sales and Use Tax Revenue (billions)*	*Percentage of Total State Revenue*
1983–84	$2.2	17.3%
1996–97	6.5	22.2
2000–01	7.7	21.2

SOURCES: Michigan Department of Treasury and Senate Fiscal Agency.

increased collections, both in absolute terms and as a percentage of total revenue, is the 1994 rate increase, from 4 percent to 6 percent, brought about by the school-finance reform package known as Proposal A; this raised the sales/use tax rate for the first time in more than 30 years, and all the additional revenue is dedicated to K–12 education. In 2001 collections were down as a share of total state revenue, in part because of an economic slowdown.

Exhibit 2 presents FY 1985–2001 actual and inflation-adjusted annual collection data. Tax collections rose every year but one (1991), but after adjusting for inflation, they essentially were flat from 1986 to 1993. Tax collections rose sharply following the rate increase, then slowed slightly, increasing at an annual rate of 2.8 percent (adjusted for inflation), then in FY 2001 fell about 2 percent.

All but five states levy a sales 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.

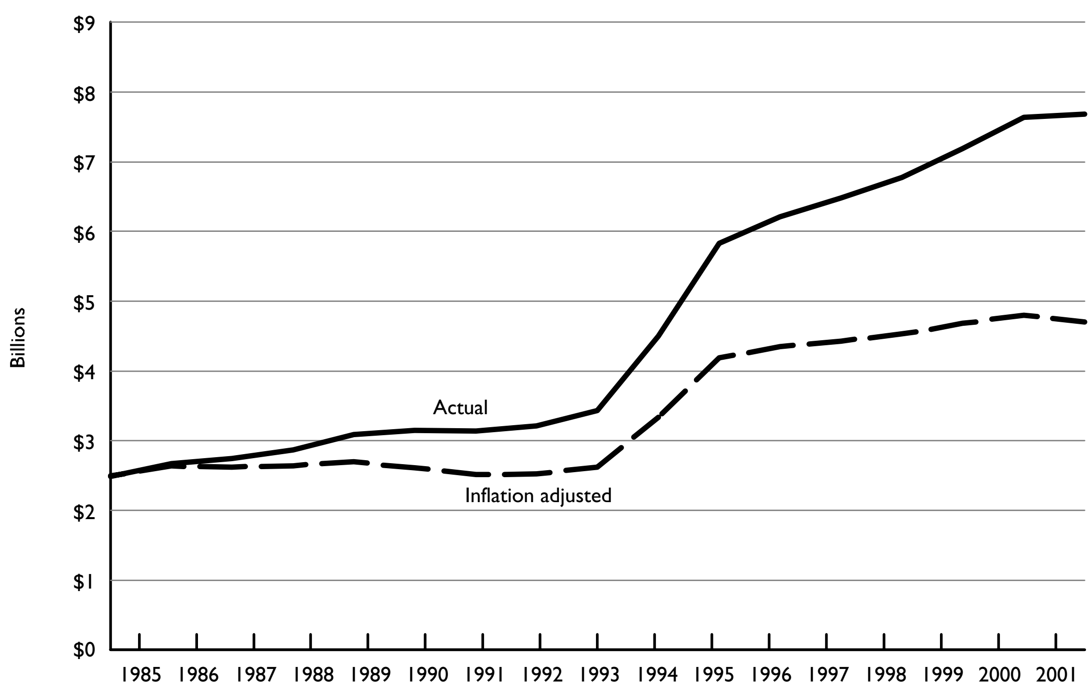
Taxes on Remote Sales

Sales/use tax revenues are being eroded by remote (mail order and Internet) sales, and the revenue lost is becoming a serious fiscal problem for state and local governments. The Michigan Department of Treasury estimates that in FY 1999–2000 the state loss was $187 million and by FY 2004–05 will be about $350 million.

There are a number of legal and practical issues that keep states from collecting taxes on remote sales, among them the U.S. Supreme Court ruling that mail-order and Internet firms that do not have *nexus* (the minimum physical presence or link that requires them to collect taxes or be subject to a state's tax system) in a state are not required to collect taxes from buyers living in that state.

Resolving the issues related to taxing remote sales will require either voluntary compliance by remote retailers

EXHIBIT 2. Michigan Sales and Use Tax Collections, FYs 1985–2001 ($ billions)



SOURCE: Michigan Department of Treasury. Calculations by Public Sector Consultants, Inc.

or congressional action. To help increase compliance by Michigan residents, the state has taken the unique approach of adding a line on the personal income tax form for calculating the amount of tax owed on remote purchases. This has met with some, but limited, success: For tax year 2000, the state collected about $3.1 million from 80,150 filers.

To address the tax collection and related issues, the Streamlined Sales Tax Project, a cooperative effort among retailers, remote-sales retailers, state and local governments, and national organizations, has been initiated. Its purpose is to simplify state sales-tax laws and rates and provide incentives for remote firms to voluntarily collect and remit the tax.

Other Consumption Taxes

On Tobacco Products

Michigan, like most states, imposes a tax, which is collected from wholesalers on all tobacco products: cigarettes, cigars, non-cigarette smoking tobacco, and smokeless tobacco. The current tax was adopted in 1994, replacing the original cigarette tax, which was adopted in 1947. The rate is

- 37.5 mills per cigarette, or 75¢ a pack; and
- 16 percent of the wholesale price on all other tobacco products.

The U.S. median per pack cigarette tax rate is 34¢ (January 1, 2002), ranging from $1.425 in Washington to 3¢ in Kentucky. Michigan's is the second highest rate in the Great Lakes region (Wisconsin's is 77¢); in Indiana and Ohio, which adjoin Michigan, the rates are 15.5¢ and 24¢, respectively.

Tobacco taxes generated about $596 million for Michigan in FY 2000–01. Of the *cigarette tax* collections,

- 63.4 percent are deposited in the School Aid Fund;
- 25.3 percent go to General Fund;
- 6 percent go to the Healthy Michigan Fund; and
- 5.3 percent are deposited in the Health and Safety Fund.

Of the *non-cigarette tobacco tax* collections,

- 94 percent go to the School Aid Fund; and
- 6 percent go to Healthy Michigan Fund.

Cigarette smuggling, both organized and casual, of cigarettes from Canada and other lower-tax states has been a problem. Not only does Michigan's high tax rate contribute to the problem, but until 1998, so did the absence on cigarette packs of any physical evidence that the tax had been paid.

In 1998 the state began to require a tax stamp on each pack of cigarettes, and experience is showing a benefit to enforcement and revenue. Smuggling is significantly down and tax-collection revenue is up. Taking into account the long-term decline in tobacco consumption that likely occurred, the cigarette stamp program saved the state an estimated $90–95 million over the first two years of the program. From FY 1998–99 to FY 2000–01, collections fell about 3 percent, about that expected from reduced cigarette consumption, indicating that little smuggling now is occurring.

On Beer

Michigan's beer and other alcoholic-beverage taxes originally were levied in separate statutes that were repealed and replaced by Public Act 58 of 1998.

Michigan has taxed beer since 1933 and currently imposes a levy on beer manufactured or sold in the state. A credit is allowed for beer shipped out of state or sold to a military installation or Indian reservation.

A tax of $6.30 per barrel is imposed, with a $2 per barrel credit for brewers producing less than 20,000 barrels annually. The rate has not changed since 1966, when it was reduced from $6.61 per barrel. Nationwide, rates range from 63¢ per barrel (Wyoming) to $29.30 (Hawaii). In the Great Lakes region, Michigan's rate is highest, and Wisconsin's, at $2.05, is lowest.

The Michigan beer tax generated about $45 million in FY 2000–01. The proceeds go to the General Fund.

On Wine

Michigan first imposed a wine levy in 1933. The tax is levied per liter, a credit is allowed for that shipped out of state or sold to military installations or Indian reservations, and the rates are

- 13.5¢ per liter for wines made from imported grapes and having 16 percent or less alcohol;
- 20¢ for wines made from imported grapes and having more than 16 percent alcohol;
- 1¢ for wines made in Michigan from domestic grapes or fruit; and

- 48¢ for mixed spirit drinks (e.g., "wine coolers").

Per gallon, the Michigan tax equates to 51¢, second highest in the Great Lakes region. Only Illinois, at 73¢ a gallon, is higher.

The Michigan wine tax generated about $6 million in FY 2000–01, and the proceeds go to the General Fund.

On Liquor

Michigan has taxed the retail price of spirits since 1959. Currently, a rate of 12 percent is levied on spirits sold for on-premise consumption and a rate of 13.85 percent on spirits sold for off-premise consumption.

The tax generated about $87 million in FY 2000–01. Of the collections,

- 29 percent go to the General Fund;
- 29 percent go to the School Aid Fund;
- 29 percent go to the Convention Facility Development Fund; and
- the remainder goes to the Liquor Purchase Revolving Fund.

Other

The property tax, which affects virtually all adults because it is paid directly by all landowners and indirectly by all renters, is not a consumption tax and is not discussed here. Readers interested in the property tax are referred to "K–12 Funding" and "Taxes on Businesses," elsewhere in this book.

Motor-vehicle fuel taxes also affect virtually everyone, either directly, at the pump, or indirectly through the taxes' effect on the cost of goods and services. Motor-vehicle fuel taxes are discussed in "Highway Funding and Safety."

DISCUSSION

Sales and Use Taxes

Debate about sales/use taxes in Michigan centers primarily on three issues.

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

First, the current sales/use tax base is shrinking relative to the economy as a whole. These taxes historically have been levied on the sales/use of tangible goods. Most services—ranging from professional business services to dry cleaning—have been exempt. However, as the state has changed, the proportion of the economy subject to the taxes has diminished. For example, in 1977 only 12.3 percent of the Michigan economy (private-sector gross state product) was attributed to service industries (and, therefore, in large part exempt from consumption taxes), but by 1999 that percentage had risen to 21.8 percent. This trend will continue, which means that Michigan is 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. Others assert that taxing services would dampen growth of the state's most dynamic economic sector.

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 earns more income. In recent years, however, tax fairness is beginning to be judged by its lifetime, rather than annual, burden on income. Analysts using the new measure conclude that the relative burden of consumption taxes is roughly equal for all income groups.

Third, since the mid-1980s sales/use taxes may not be deducted against one's federal income tax liability. Some analysts argue that this change has raised the total burden of the sales/use 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, 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 sales/use taxes have certain advantages.

- Some portion of the tax burden may be exported to non-Michigan residents who travel into this state. An estimated 5–15 percent of all Michigan sales/use tax revenue comes from sales to nonresidents.

- Some point out that the public finds sales/use taxes more palatable than other levies because purchases are made at the consumer's discretion. A family may forgo, delay, or accelerate buying items subject to the sales tax, depending on current circumstances.
- Some believe an important criterion of a good state tax system is "balance"—having roughly the same reliance on all revenue sources. In Michigan, since the 1994 sales/use tax increase, the state annually generates roughly about the same amount from both consumption taxes and income taxes.

Taxes on Remote Sales

The most serious problems in collecting taxes on remote sales are the wide differences in (1) rates levied by state and local governments and (2) how the thousands of taxing jurisdictions define what is taxable and what is not. If the states can simplify and standardize tax law and collection procedures, the undue burden that the multitude of rates/definitions imposes on remote-sales merchants would be eliminated, weakening the position that the Commerce Clause of the U.S. Constitution excuses firms without nexus from collecting the purchaser's state tax.

The most recent remote-sales action in Michigan is P.A. 122 of 2001, which makes Michigan a partner with 19 other states in the Streamlined Sales Tax Project, which has as its objective developing a way to collect state taxes on Internet, catalog, and telephone sales. The law's provisions

- allow the state to enter into a multistate sales/use tax agreement;
- create a board of governors that can represent the state in relevant meetings with other states;
- provide for registering Internet and catalog sellers, who would have to select a way to collect and remit sales/use taxes;
- allow Internet and catalog sellers to contract with certified service providers for collecting and storing the taxes;
- permit use of an automated system to calculate each jurisdiction's tax on a transaction;
- limit Internet/catalog sellers' liability for taxes on transactions made before a seller registers; and
- provide for consumer privacy.

Supporters of taxing remote sales point to the revenue it would bring in, which is especially important because three-quarters of state sales tax revenue goes to K–12 schools and about one-third to local units of government. They also assert that there are fairness issues: Taxing remote sales would assure fairness to (1) Michigan merchants who must compete against remote merchants and (2) people who cannot afford computers to do their shopping.

Opponents also cite fairness issues: They say that (1) Internet and catalog vendors with no physical presence in a state receive none of the benefits of the taxes they would have to collect and remit at some expense to themselves, and (2) consumers who buy from home are not using the roads or many other state services they use when they go to a store. Opponents also are concerned about privacy. They say one of the advantages of the sales tax over other taxes is anonymity—in a store, shoppers do not have to give their name or address, and their buying habits are not tracked; a national, third-party tax-collection system may require such individual information.

Tobacco and Alcohol Taxes

Current public policy debate in Michigan about tobacco taxation revolves primarily around how the revenue is spent. Some wish to see more go directly into tobacco-use prevention and cessation programs. Others believe that state prevention and cessation spending is adequate, pointing out that in addition to specific programs, the state addresses tobacco use through school and health programs.

There currently is no public policy debate in Michigan on the subject of alcohol taxes.

See also Highway Funding and Safety; K–12 Funding; Local Government Organization and Issues; Taxes on Businesses; Tobacco Settlement.

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