Economic Impact of Taxing Professional Services in Minnesota

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Minnesota lawmakers have floated the idea of generating additional revenue by extending the state sales tax, which is generally designed to be levied on consumer purchases, to professional services. This report investigates the economics of this policy, explains why a professional services tax is not advisable, and presents a macroeconomic analysis of the negative impact in Minnesota if professional services were to be subject to the state sales tax.

Minnesota Economy

Minnesota is currently seventeenth in the nation in terms of GDP (*Bureau of Economic Analysis, 2019*), and the state's unemployment rate has been consistently lower than the U.S. unemployment rate since 2008. But Minnesota's GDP growth has lagged national GDP growth since the Great Recession. And, while the state currently enjoys a projected budget surplus, Minnesota Management and Budget (MMB) recently reported a weakening outlook for the state's economy and budget. The state's employment growth is slowing as Baby Boomers retire, and revenue projections are shrinking (*MMB, 2019*). The prospect of a weakening budget and economic outlook may propel interest among state legislators to generate additional revenue through new taxes.

In 2017, legislation was introduced to tax professional services in Minnesota (*SF No. 2428*). Given that professional and business services were the largest contributor to Minnesota's real GDP growth in 2018 (*Bureau of Economic Analysis, 2019*), it is important for Minnesota lawmakers to recognize both the negative impact of this type of tax and the importance of this sector to the Minnesota economy.

Professional Services Tax

State sales taxes are collected in 45 states and the District of Columbia. Rates range from 2.9 percent (Colorado) to 7.25 percent (California). At 6.875 percent, Minnesota's sales tax rate is the sixth highest (*Cammenga, 2019*). Like many states, Minnesota has a use tax, which requires residents to pay the state sales tax on applicable out-of-state purchases. In Minnesota, the sales and use tax generally applies to consumer goods, though certain items (such as groceries and prescription or over-the-counter medicines) are exempt. Goods sold to businesses generally are not subject to the tax.

There is well-established tax theory behind exempting business purchases from a sales tax. In short, a sales tax should be applied at the final point of consumption to avoid taxing any input more than once and to avoid distorting firm decision-making. As American Enterprise Institute tax economist Alan Viard (2010) has noted, taxation of business purchases leads firms to choose untaxed inputs when possible and to vertically integrate to avoid the tax.

When it comes to professional services provided to businesses, there are additional problems with applying a sales tax. As Ernst & Young economists have observed, "To the extent that services are primarily consumed by business, such as professional services, including these business-to-business sales in the sales tax base will have a significant negative consequence: putting in-state companies at a competitive disadvantage relative to out-of-state competitors" (*Cline, Phillips, and Neubig, 2013*).

There are also substantial compliance burdens for businesses in calculating and paying sales tax on professional services. Considering the numerous downsides, it is unsurprising that several states that enacted these taxes have repealed them (*Professional Services Alliance, 2018*).

Macroeconomic Analysis of a Professional Services Tax in Minnesota

To demonstrate the negative impact of a professional services tax in Minnesota, we apply the state sales tax to specific service industries within a model of the Minnesota economy. This model was built by IMPLAN, whose regional input-output models are widely used in government, academic, nonprofit, and corporate settings. Using publicly available historical data for a region or state, IMPLAN models project economic indicators – for example, production, employment, and demand – by industry. For the analysis presented here, a professional services tax is modeled against the baseline forecast for Minnesota.

A tax on professional services would effectively raise the price of these services, and the IMPLAN model shows the impact of this price increase across the Minnesota economy. This analysis focuses on the impact of the tax on private-sector employment, output (or GDP) within the state, and labor income of Minnesota residents.

Assumptions

We assume that the following eight industries would be subject to the 6.875 percent sales tax beginning January 1, 2020:

- Accounting, tax preparation, bookkeeping, and payroll
- Architecture and engineering
- Commercial banking
- Computer programming and design
- Insurance
- Legal
- Management consulting
- Real estate

We assume that exports – that is, Minnesota-based professional services provided to out-of-state customers – would not be subject to the tax. And we assume that imports – that is, out-of-state professional services purchased by Minnesota-based customers – would be subject to the tax, in keeping with the use tax Minnesota already requires. This likely makes the estimated impact conservative since use tax compliance can be difficult to enforce. The estimated impact is also conservative because the analysis does not include sales taxes that Minnesota cities and counties collect.

As **Table 1** shows, business-to-business sales represent the majority of consumption in every industry subject to the tax in this analysis.

TABLE 1. BUSINESS VS. HOUSEHOLD CONSUMPTION OF EIGHT PROFESSIONAL SERVICE INDUSTRIES

		SHARE CONSUMED BY		
INDUSTRY	OUTPUT ($ BILLIONS)	BUSINESSES	HOUSEHOLDS	GOVERNMENT
Accounting, tax preparation, bookkeeping, and payroll	$3.2	84.2%	10.5%	5.3%
Architecture and engineering	$4.5	89.4%	0.0%	10.6%
Commercial banking	$13.8	63.8%	35.4%	0.8%
Computer programming and design	$8.1	89.4%	0.0%	10.6%
Insurance	$19.3	67.4%	32.3%	0.3%
Legal	$6.1	67.1%	28.8%	4.1%
Management consulting	$4.4	94.0%	0.0%	6.0%
Real estate	$31.8	68.1%	29.6%	2.3%

Results

The analysis shows that a sales tax on professional services would have a negative impact on the Minnesota economy that increases over the decade modeled. This impact would not be confined to the taxed industries. To the contrary, after professional, scientific, and technical services, the industries experiencing the greatest job loss in 2029 would be administrative and support services and food and beverage services. This reflects the interconnectedness of the economy and demonstrates how the impact of the tax would ripple across sectors.

Employment

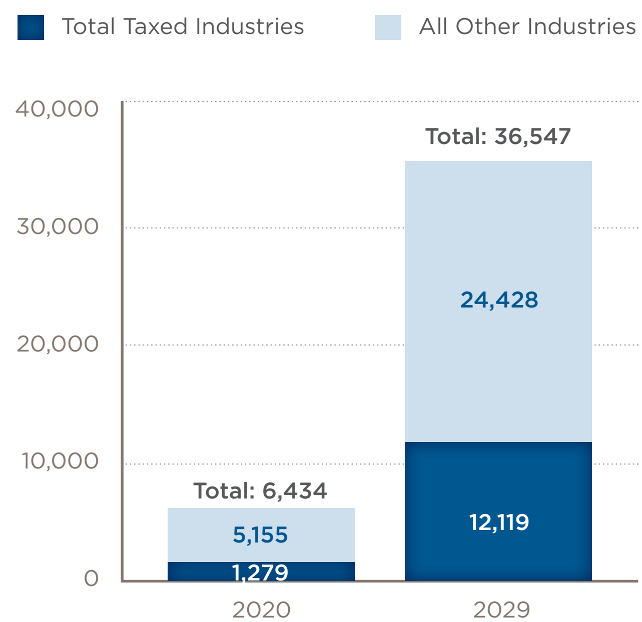
In the first year analyzed (2020), a professional services tax could be expected to result in a drop in employment of more than 6,000 jobs, with job loss increasing nearly sixfold by 2029. **Table 2** shows the employment impact at the beginning and end of the decade modeled.

As **Chart 1** shows, job loss in other industries would be twice the job loss in taxed industries by 2029.

TABLE 2. IMPACT OF PROFESSIONAL SERVICES TAX ON PRIVATE NON-FARM EMPLOYMENT, 2020–2029

INDUSTRY	2020	2029
Accounting, tax preparation, bookkeeping, and payroll	-103	-1,156
Architecture and engineering	-80	-967
Commercial banking	-283	-2,737
Computer programming and design	-129	-1,440
Insurance	-156	-1,443
Legal	-106	-938
Management consulting	-121	-1,574
Real estate	-301	-1,864
Total Taxed Industries	**-1,279**	**-12,119**
All Other Industries	**-5,155**	**-24,428**
Total Employment Impact	**-6,434**	**-36,547**

CHART 1. PRIVATE NON-FARM JOB LOSS DUE TO PROFESSIONAL SERVICES TAX, 2020 AND 2029



Output

A tax on professional services would reduce Minnesota's GDP by more than $4 billion in 2029 (see **Chart 2**). As a share of the total drop in GDP, the taxed industries represent approximately 45 percent. This is notably higher than share of total employment accounted for by the taxed industries (roughly one-third) because the labor productivity of professional services industries is high relative to other industries.

Labor Income

Labor income in Minnesota would steadily decline over the decade as a result of the professional services tax (see **Chart 3**). By 2029, Minnesota workers would be earning $2.9 billion less than they would in the absence of the tax.

CHART 2. IMPACT OF PROFESSIONAL SERVICES TAX ON GDP, 2029 ($ BILLIONS)

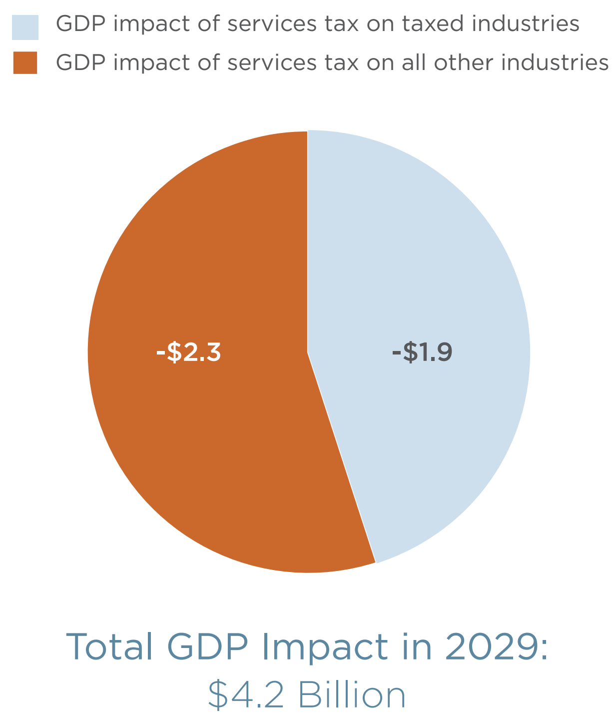
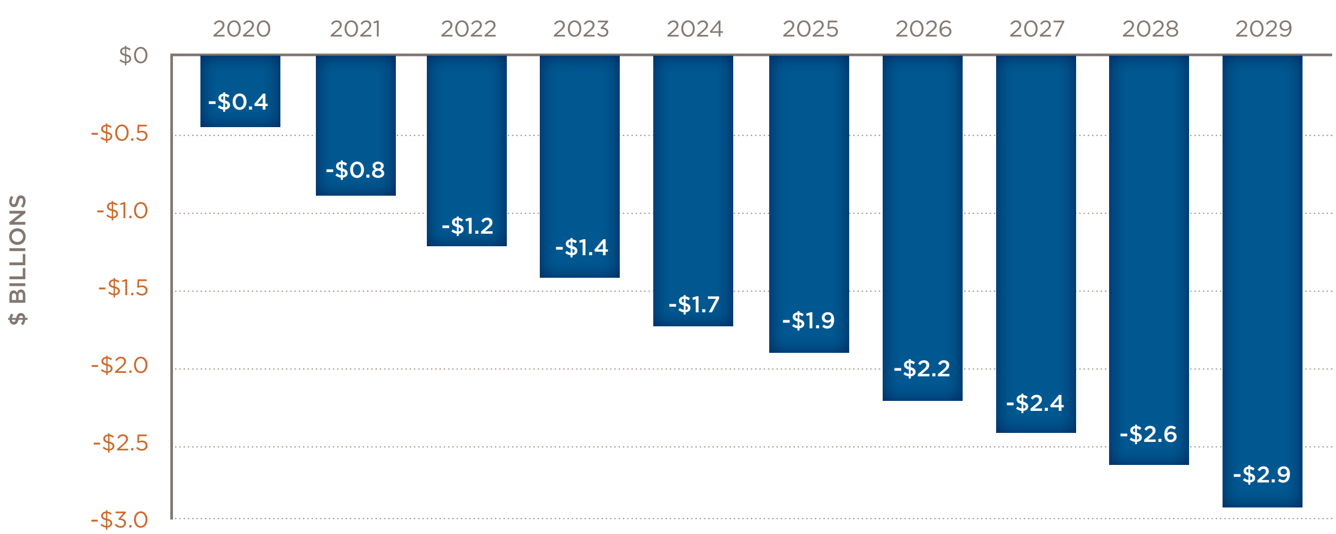


CHART 3. IMPACT OF PROFESSIONAL SERVICES TAX ON LABOR INCOME, 2020–2029



Conclusion

The majority of professional services are provided to businesses, and tax theory tells us that taxing business-to-business sales is not good policy. A tax on professional services would also drive business out of the state that levies the tax. In fact, given the progress in information technology and digital communications, the adverse impact of a professional services tax in Minnesota would be more severe today than just a decade ago. The analysis detailed in this report shows the negative consequences that a tax on professional services would have for Minnesota's workers and economy.

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