

## Michigan Fair Tax Manifesto

03 July 2008

Dear Legislators,

After more than thirty years, the people of Michigan realized that the Single Business Tax (SBT) was a huge factor in this state's economic slump. Through the petition process, and with legislative help, it was repealed in 2006. Given the overwhelming unpopularity and negative impact of the SBT, that move was a great idea. Unfortunately, its replacement just made the problem worse.

Within the various engineering fields there is a universally-recognized concept called Einstein-Hopper Insanity. It's defined as doing things the same way over and over again (because that's the way we've always done them), only expecting that the results this time will somehow be different. In replacing the SBT, we have done this very thing.

Over the past few months, throughout the state, there have been hearings, meetings, and conferences regarding the Michigan Business Tax (MBT) and its impact on our state's business sector. The association I work for has sat in on each of these. As a general rule, we've listened to business owners, CEOs, and accountants explain and complain that the MBT is infinitely more complex than the SBT (to the point of incomprehensibility), and increases their tax burden by no less than fourfold.

Companies that have been operating more or less smoothly for the past three dozen years are now, for the first time in their corporate histories, being forced to enact at least one round of layoffs. And that's assuming that their tax burden doesn't force them out of business outright, which is occurring with an increasing frequency. And all of the university professor economists in this state misrepresenting the data to make our economy look better than Mississippi's (it isn't) is nothing more than beautiful frosting over the lousy cake of the status quo. Someone really needs to explain to me how a 1.6 percent jump in our state's unemployment rate (56,000 jobs permanently blown away) from April 2008 – or a 1.4 percent jump from last year – is not so bad, because I'm not getting it.

Now maybe I'm missing something here, but it seems to me like replacing one business tax system with another one (and a worse one at that) amounts to a classic example of the insanity I mentioned three paragraphs ago. And, with the Michigan economy in the equivalent of a death spiral, now the talk in Lansing is of 'tweaking' the MBT in order to correct its flaws (perhaps by reducing or eliminating the surcharges). Doesn't this amount to the equivalent of rearranging deck chairs on the Titanic . . . after it hit the iceberg?

I'm going to use a current real-life example that beautifully illustrates the point that I'm going to make in this letter: On April 22<sup>nd</sup>, MPI Research Partners announced that they would be starting up a downtown Kalamazoo facility that would create somewhere around 3,300 jobs locally, about that many in the surrounding county, plus provide a bunch of indirect employment opportunities due to their economic impact. However, in order to attract that company, Governor Granholm had to sign off on an 86 million dollar tax break spanning the next ten years.

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Did I miss something here, or did she just admit – on the record – that the most reliable way to attract businesses to Michigan is to relieve them of their business tax burden? Come on, what did I miss? And while I'm at it, how is the state going to make up for that revenue hole?

If we can attract one company, and at least 6,000 jobs, by providing a temporary business tax break, then how many companies might we attract, and how many jobs might they bring with them, if we permanently eliminated all Michigan business taxation? Seriously, why are we still fiddling around choosing economic winners and losers with a tax system that's nothing more than a perverse mutation of the tax system that created the very mess that Michigan is in? According to Albert Einstein, "We can't solve problems by using the same kind of thinking we used when we created them." This is where you go back five paragraphs and reread that definition of Einstein-Hopper Insanity.

Michigan is being taxed into the ground, and this absolutely must stop if we are to ever permanently solve this state's economic issues. The current state tax system penalizes Michiganders for working more effectively and becoming more successful. As we each climb the ladder of success, our own state government continually takes a bigger bite out of our earnings, property, and savings.

So no matter how hard Michiganders work, no matter how innovative and creative we are, no matter how superior the products we produce and services we provide, we are ultimately hamstrung by the built-in competitive disadvantage of our state tax system. Why? Honestly, given the hassles associated with the tax filing and reporting process, the endless reams of forms and paperwork, and the cumbersome rules and Byzantine changes, don't you think it's time to stand up and say, "Enough already!"? I certainly do.

The sad thing is that the solution to this mess was introduced to the Michigan Legislature on 08 May 2007, when you were supposed to be figuring out how to replace the SBT. And if it had actually been brought it out to the floor for a vote, then this whole MBT mess could have been avoided to begin with. The headaches and confusion associated with the Michigan Business Tax are but the latest example of a state tax system that is antiquated, and broken beyond all repair. The MBT should be scrapped outright – including the rest of the state-level personal and business tax system with it – and replaced with the Michigan Fair Tax (MIFairTax).

On March 3<sup>rd</sup>, 2005, Alan Greenspan testified before the President's Advisory Panel on Federal Tax Reform. Though speaking with respect to federal tax reform, his thoughts on a comprehensive overhaul of the tax system are pertinent to our discussions here in Michigan:

"The 1986 tax reform effort is widely regarded as having been the most successful of the post-war era . . . A defining feature of the 1986 reform was the broadening of the tax base and the lowering of tax rates, and it is widely believed that these changes enhanced economic efficiency . . . Moreover, distortions arise when similar activities are subject to different tax treatments . . . Lowering tax rates [and] broadening the tax base generally will reduce the costs of such distortions . . . A simpler tax code would reduce the considerable resources devoted to complying with current tax laws, and the freed-up resources could be used for more productive purposes. Thus, greater simplicity would, in

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and of itself, engender a better use of resources. A principle that I believe is important now – but appears not to have weighed so heavily on those involved in the earlier reforms – is predictability in the tax code. By this I mean creating a tax system in which households and businesses can look into the future and have some reasonable degree of certainty about the future tax implications of decisions made today . . . The choice of the tax base and other provisions of the code must also be taken in light of coming demographic changes. I believe that, as the baby boom generation begins to retire in a few years, it will become increasingly important for the nation to boost resources available in the future through greater national saving and enhanced incentives for participation in the labor force. The tax system has the potential to contribute importantly to those goals, and, at a minimum, tax reform should not hinder the achievement of those objectives.”

So, according to Doctor Greenspan, an effective tax reform does each of the following things:

- ✓ Broadens the tax base and simultaneously lowers the general tax rate
- ✓ Taxes similar economic activity identically
- ✓ Is simple, easy to understand and comply with, and predictable
- ✓ Accounts for demographic changes
- ✓ Encourages savings and investment
- ✓ Enhances incentives for participation in the labor force

Let’s think about each of these points for a bit.

Under the current income-based tax system, the current Michigan Department of Treasury estimates are that Michigan will have a \$2.5 billion revenue shortfall this year due to unreported and underreported income. Based on Michigan’s population, that’s an income tax non-compliance rate hovering around twenty percent. However, the FairTax is a consumption-based tax system. This means that the tax is applied at the point of final retail sale. Conventional wisdom holds that America is a consumption society, and mere observation of people going about their day-to-day affairs shows this to be so. Whether it’s groceries, gasoline, clothing, entertainment, durable goods, titled property, or anything else, everyone reliably generates consumption at some point.

Today, Michigan residents are directly paying a 4.35% income tax and a 6.0% sales tax. But those are not all the taxes that residents pay. Businesses treat compliance costs for taxes just like any other expense; they pass the costs on to consumers. When federal and state business taxes are included, an average of 22 percent of the on-the-shelf price of everything – groceries, gasoline, clothing, entertainment, durable goods, titled property, or anything else – is taxation ‘embedded’ in the form of higher prices. (Business taxation, like any other cost of doing business, must be passed on to the consumer to ensure profitability). These numbers, added together properly, make the Michigan Fair Tax sound as reasonable as it truly is.

The FairTax starts from the general economic axiom (quoted by Ronald Reagan and Alan Greenspan, among others) that “businesses don’t pay taxes; people do,” and seeks a means of taxation that includes the most number of people legally possible. As we have already observed,

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economic consumption is effectively a given. Based on spending history, the sales tax rate calculated to meet the needs of the 2006-2007 budget cycle, as the budget was originally approved, is 9.75 percent. That's it . . . period. The broadest possible tax base (all consumption spending in Michigan) and the minimum tax rate needed to ensure budget solvency. As a bonus, we eliminate the hidden taxation that is costing Michigan dearly in employers and jobs.

The fact of the matter is that business taxation is a lie anyway, because no such taxpayer exists. To tax a business is to tax the people who work there (in the form of smaller paychecks and reduced job opportunities), or buy its product or service (in the form of higher prices), or own its stock (in the form of reduced dividends and profitability). Either way, when corporations get taxed, real men and real women pay the price, not some faceless entity. If you can't have dinner with it, then you can't tax it.

And what message are we sending businesses when we tax one at a different rate than another? Based on the tax abatement per job granted to MPI Research Partners, it would cost the state about \$12.7 billion in handpicked carve outs to buy back the 490,000 jobs that Michigan has lost since 2001. That would force the State of Michigan to file bankruptcy! Is that a precedent we want to set? If selective temporary tax favors are what it takes to get business to come to Michigan and boost the economy, then what do you think would happen if Michigan permanently cut all taxes to all businesses?

Now admittedly, Michigan has an income tax rate that is nominally flat. But there are loopholes – in the form of exemptions and deductions – that not every taxpayer has access to. And this assumes that taxable income is properly declared in the first place. The ‘underground economy’ (the market consisting of all commerce on which applicable taxation is avoided) exists. This isn't only illegal commerce, but also otherwise perfectly legal business transactions that are conducted on a cash-only/no-receipt basis to avoid business taxation. Under Michigan's current tax system there is no way to reliably tax this activity, and there never will be because there are too many points of collection to monitor effectively. Thus an income-based personal tax system is inconsistent in application by its very nature.

The FairTax, on the other hand, does not tax anything but spending, and then only spending on new goods and services. Everyone who is a consumer will also be a taxpayer, including those who participate in the underground economy.

According to Albert Einstein, “The hardest thing in the world to understand is the income tax.” And he has a point. If complexity worked, then Michigan would be the most prosperous state in America, because we have the most complicated state tax system in the nation. The evidence, in the form of a contracting economy (1.2% GDP reduction in 2007 – only Delaware was worse), high unemployment (8.5% in June 2008 – only Puerto Rico was worse), and nation-leading outbound migration (67.8% of all Michigan inter-state moves in 2007 were outbound), suggests otherwise. Now I would be naive to assume that taxes are the only driving factor behind these changes, but I would be foolish indeed to think that taxes aren't at least one of the major reasons that businesses, jobs, and workers are leaving Michigan as quickly as possible.

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The FairTax, on the other hand, is based on the one tax that has near-perfect compliance (98.4%, historically), because there are no loopholes in a retail sales tax (and fewer collection points to track helps). The concept is very simple in that if one is buying a new good or service at retail, then one pays a tax, otherwise not. The means to collect and transmit sales tax is already in place, and will require only a minimal amount of adjustment to comply with the FairTax. The FairTax is also predictable in that people will know that the only time they'll pay state taxes again is when they spend their money.

I don't know if the current Michigan tax system (outside of Oakland County) projects for future demographic changes or not, but I do know that MIFairTax does. The guaranteed revenue sharing feature back to counties and local governments is based on percentages and population. Because the percentages are based on sales revenue, tourist spending will impact the percentages, at least seasonally. As the absence of business taxation attracts companies to Michigan, the accompanying population shift will also impact revenue sharing. And these adjustments are built into the FairTax system, so that it's self-correcting. Additionally, right now 84% of school funding is provided through the current sales tax, but the FairTax will provide almost all school funding.

“Anything that we can do to raise personal savings is very much in the interest of this country.” (This is an Alan Greenspan quote.) Right now, the Social Security system is in danger of insolvency, medical costs are skyrocketing, and college expenses are out of reach for most Michigan residents (absent some form of state assistance – see Professor Laurence Kotlikoff <http://taxfoundation.org/podcasts/podcast8.pdf>, or listen to the interview at <http://taxfoundation.org/podcasts/podcast8.mp3>). These are some things that savings and investment are supposed to be used for. But the current income-based tax system not only taxes earnings, but also savings interest and investment dividends. Taxing anything creates a disincentive for that particular behavior, which then begs the question: why would we tax behavior that common sense dictates we should desire?

The idea behind working for a living is to start from scratch, become proficient and productive in a chosen career, and eventually retire financially independent.

The typical progress of this concept is that one will start immediately post-school, usually living out of one's parents' house, working a minimum-wage, grunt-work job. Eventually, the individual becomes sufficiently self-supporting as to afford the expenses of a simple apartment and a usable used car. Over time, the entry-level job leads to increased responsibility and pay, the rented apartment becomes a mortgaged house, and the 'beater' is replaced with something newer. The end result, assuming that the individual is sensible enough to live within his means, is a paid-off house and car, and sufficient liquid assets to retire at an acceptable standard of living.

An income-based tax system progressively taxes people as they become more productive and contribute more to society – which works directly against the core notion of the 'land of opportunity.' The Fair Tax, on the other hand, is a consumption-based tax system that does not tax earnings in any form, including savings and investment. Thus only consumption and

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borrowing for the purpose of consumption is discouraged. Historical sales trends indicate that this discouragement will only be nominal.

Reviewing briefly, according to Doctor Greenspan, an effective tax reform does each of the following things:

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- ✓ Taxes similar economic activity identically
- ✓ Is simple, easy to understand and comply with, and predictable
- ✓ Accounts for demographic changes
- ✓ Encourages savings and investment
- ✓ Enhances incentives for participation in the labor force

The FairTax, by design, does these things:

- ✓ Taxes the broadest possible base (all consumption spending) with the minimum tax rate needed to ensure state budget solvency
- ✓ Taxes only consumption spending on new goods and services . . . but does not tax anything else
- ✓ Uses a known taxation method (that is not considered burdensome) that has a history of high compliance because of its simplicity and non-invasiveness
- ✓ Provides a guaranteed revenue share back to counties and local governments that automatically adjusts for spending trends and population shifts
- ✓ Does not tax savings and investments, thereby removing the disincentives for this valuable economic behavior
- ✓ Does not tax earnings in any form, thereby allowing workers to keep more of their paychecks to spend. This also includes business income, which means that companies will be able to use their tax savings to create more jobs.

By this measure then, the FairTax fits the definition an effective tax reform.

The Michigan Fair Tax Association (MFTA) has been collecting signatures since mid-February of this year in an effort to put the FairTax Proposal on Michigan's November ballot. That should have been irrelevant. The referendum process (in Michigan or any other state) is intended to be a way to have the voters' voices heard when their elected legislators refuse to act according to the wishes of their constituents – not as the primary means of putting an issue on the statewide ballot.

And I tell you the truth when I say that there are voters all over Michigan who want the FairTax Initiative on Michigan's November ballot. I can say this with certainty because I have personally reached into 47 counties in Michigan, and I have the signatures of voters who expect you to support the FairTax Initiative . . . or they will refuse to support you.

There is too much at stake, and we have reached the point at which a person needs to look beyond politics, take a stand, and say enough is enough. I ask the hard question: What do you stand for, and what is our government's plan? Please take another hard look at the Michigan Fair

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Tax Proposal and at the economic results of our current state tax system. I'm confident you want to do the right thing for our state, and all you need to know is what that right thing is.

Your constituents expect you to do whatever is necessary to get the Michigan Fair Tax Initiative out onto the floor for a vote. Further, they expect you to coordinate with whoever is necessary to make sure that a two-thirds majority votes to put the FairTax proposal on the ballot for a November general vote. Taxpayers United for Michigan has clearly warned you that a taxpayer revolt is brewing in this state . . . a warning that I would consider seriously if I were you.

As I mentioned earlier, Michigan's economy is in the equivalent of a death spiral, and our current tax system is forcing businesses, jobs, and workers out of this state at an ever faster rate. (I shudder to think what July's unemployment numbers will be.) Fundamental change is never easy; I get that. But the voters who elected you to office, and empowered you to represent them, also expect you to take whatever action is necessary to put Michigan's financial house in order.

I'm a pretty realistic guy. So I cannot believe, given an even choice, that Michigan voters would approve the worse of two options. All I am asking of you (along with the voters who put you into office) is to put the FairTax Proposal onto Michigan's November ballot. Then between now and Election Day we'll see to it that the state's electorate is fairly and thoroughly educated on the pros and cons of the FairTax. I trust that Michigan voters will then select the better of the two tax plans for our state's economic future.

If you have any questions or concerns regarding the FairTax Proposal, then feel free to contact me, and I will address any such that you may have. Questions are always a great way to learn, and I'll make sure that you get the answers you need.

Sincerely and Respectfully,

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