

A tax proposal that should not fall flat

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CANADIAN governments looking for ways to improve the economy would do well to consider Ontario Progressive Conservative (PC) leadership candidate Christine Elliott's bold plan to implement an 8% flat tax should she be elected premier (Elliott, 2009). Ironically, Elliott's husband is federal finance minister Jim Flaherty, whose government has favoured reductions in the GST over personal income tax cuts. Indeed, Minister Flaherty should take a page from Elliott's policy playbook. By removing the current tax penalty on success, a flat tax would revolutionize Canada's tax system and unleash the efforts of hard-working and entrepreneurial Canadians.

It is important to understand that replacing multiple personal income tax rates with a single rate, as Elliott proposes, is only one step towards an integrated flat tax. A true flat tax is an integrated approach to taxation that applies a uniform tax rate to all sources of income, personal and business. In addition, an integrated flat tax would dramatically simplify the tax system by eliminating nearly all deductions, exemptions, and credits that complicate the existing system. The flat tax discussed here relates to a single rate income tax.

Currently, all of Canada's governments, federal and provincial (with the

exception of Alberta), maintain graduated or "progressive" personal income tax rates. For example, Ontario has five income tax brackets starting at 6.05% for incomes up to \$36,848 and increasing to 17.4% for incomes over \$76,442. The federal government maintains four income tax brackets, starting at 15% for incomes up to \$38,832 and increasing to 29% for incomes over \$126,264 (CRA, 2009).

Graduated income tax rates create strong disincentives for people to work hard, save, invest, and engage in entrepreneurial activities. To understand how progressive tax rates act as a disincentive for Canadians to become more successful, it is useful to think of how progressive fines are used to curb fast driving. Speeding tickets are more costly depending on how high above the posted limit we drive, and are meant to discourage excessive speeding. While that is certainly not the intention, progressive income tax rates have the same effect in that they discourage hard work and success.

When individuals make decisions to increase their incomes through working harder or longer, increasing their savings and investments, or starting their own business, their marginal tax rate (the tax rate they pay on the next dollar they earn) influences their behaviour. The more governments take of every additional dollar that someone earns, the

FURTHER READING:

*The Impact and Cost of Taxation in Canada:
The Case for Flat Tax Reform*
edited by Jason Clemens
Available at www.fraserinstitute.org.

less likely people are to engage in efforts to earn more.

Academic research overwhelmingly shows that when tax rates increase as individuals earn more money through hard work and success, they act as a disincentive for those activities (Palacios and Harischandra, 2008).

Interestingly, the destructive impact of Canada's graduated personal income tax rates has not been lost on consecu-

means that the share of income one pays in taxes increases as one earns more income. To achieve progressivity, it is not necessary to have increasing personal income tax rates.

Consider Elliott's plan, which would result in a single tax rate of 8%, applicable to all income over \$18,000, her proposed personal basic exemption (the amount of income one can earn tax-free). An individual earning \$30,000 in

celled the planned elimination of the personal income surtax.

While the 2009 Ontario budget demonstrated that the McGuinty government has finally realized the harmful effects of high and increasing taxes, the budget failed to reduce middle and upper personal income tax rates (Lammam and Veldhuis, 2009).

Regardless of the outcome of the Ontario PC leadership race, Ontario—and indeed the federal government—should implement a single rate personal income tax. Doing so would provide true stimulus for wealth creation now and in the future.

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tive federal governments, both Liberal and Conservative. In 2005, then Prime Minister Paul Martin's economic plan, *A Plan for Growth and Prosperity*, proclaimed that "Lower personal taxes would also provide greater rewards and incentives for middle- and high-income Canadians to work, save and invest" (Canada, Department of Finance, 2005).

Similarly, current Prime Minister Stephen Harper's economic plan, *Advantage Canada*, stressed that "Canada's tax burden on highly skilled workers is too high relative to other countries ... Canada needs lower personal income tax rates to encourage more Canadians to realize their full potential" (Canada, Department of Finance, 2006).

Unfortunately, despite their lofty rhetoric, neither the Martin-led Liberals nor Harper-led Conservatives have moved to reduce middle and upper personal income tax rates.

This may be the result of pressure from social activists who oppose flat taxes on the grounds that it is only fair that the tax system be progressive. Unfortunately, these activists confuse increasing personal income tax rates with progressivity. Progressivity simply

Ontario would only be taxed on \$12,000 (\$30,000 minus the \$18,000 exemption) and pay \$960 in income tax for an average rate of 3.2%. An individual who makes \$100,000 would be taxed on \$82,000 and pay \$6,560 in tax for an average rate of 6.6%. Because the personal exemption constitutes a much higher portion of income for the individual making \$30,000, a much smaller portion of their total income is subject to tax. As a result, introducing a single rate income tax would remove a significant barrier to success *and* keep the tax system progressive.

Thankfully, some provinces are making progress to reduce middle and upper personal income tax rates. Alberta has benefited greatly from its 10% single rate personal income tax. Most recently, New Brunswick introduced a plan to replace its four tax brackets with just two rates of 9% on income less than \$37,893 and 12% on income above that amount (Veldhuis et al., 2009).

Ontario, however, is a different story. Shortly after coming to power in 2003, the McGuinty government increased personal income taxes by introducing the Ontario Health Premium and can-

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