

The flat tax— a model for reform of personal and business taxes

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The flat tax is a viable model for broad-based reform of both personal and business taxes. This chapter, which is based on *Flat Tax: Principles and Issues* (Emes and Clemens 2001), a comprehensive evaluation of the flat tax, is focused on the reform of personal income taxes. There are three sections. The first summarizes where the current tax system fails when judged by traditional tax-policy criteria: efficiency, fairness, and simplicity. Also contained in the first section is a review of previous economic research on the costs of increasing marginal tax rates, one of the main problems with the current personal income tax system. The second section presents an overview of the flat-tax model developed by Professors Robert E. Hall and Alvin Rabushka (1995) of the Hoover Institution. The third section presents a number of flat-tax alternatives to the current federal and provincial personal income tax systems.

1 Failures in the current tax system

The traditional evaluative criteria for tax policy are efficiency, fairness, and simplicity. Comparing today's tax system with a flat tax according to these three criteria results in a strong case for the introduction of reforms based on a flat tax. The following section summarizes the failures of the current system and shows how a flat-tax system based on the work of Hall and Rabushka overcomes such problems.

Efficiency

Efficiency requires that economic distortions be minimized when taxes are imposed. The current Canadian tax system distorts economic decisions and, therefore, the allocation of resources in many ways. These distortions show up as tax incentives that effectively make some activities less expensive than others.

For example, there are a number of tax-based distortions in the field of investments. Such tax incentive programs, for instance, target resource exploration and venture capital investment. They effectively reduce the cost of making investments in these areas and, therefore, implicitly increase the relative marginal cost of making investments in other areas.

Another example of a tax-based distortion exists in the area of education. The tax system makes formal post-secondary education at an accredited university or college less expensive through the provision of tax credits. This, therefore, makes those programs that are not eligible for tax credits, such as professional and job-specific training programs relatively more expensive. This type of tax-based distortion leads to the allocation of too many resources to formal post-secondary education and not enough resources allocated to professional and job-specific training.

A flat tax removes all or nearly all of these tax-based biases. It minimizes the economic distortions attributable to the tax system and allows a more efficient allocation of resources.

Equity

Equity, also often called fairness, has two components, horizontal and vertical.

Horizontal equity

Horizontal equity requires that individuals or households with similar incomes face similar tax burdens, something not present in today's system. Certain types of income, such as some work-related benefits, face no taxation while other types of income, particularly business-related income, face multiple layers of taxation.

For instance, income earned from investments in corporations is taxed several times. First, the underlying investment is subject to corporate income tax and a variety of other taxes. The investor then pays income tax on any remittances from the corporation received in the form of dividends. The investor also pays capital gains taxes when the asset is sold, assuming that there is a nominal gain.

The government has responded to this particular issue by taxing different types of income at different rates. For example, the current top marginal federal tax rates are: 29.0% for interest and ordinary labour income, 14.5% for capital gains, and 19.6% for Canadian dividends (PricewaterhouseCoopers 2001). It is obvious that this tax structure adds considerably to the complexity of the system.

There are also biases towards two-income families and against one-income families. These biases are due to a difference between the value of the basic and spousal exemption and the fact that concentrated income by one earner reaches higher marginal tax rates than the same level of income earned by multiple earners. The analysis contained in *Flat Tax: Principles and Issues* shows how the personal income taxes of two sample families with similar incomes and similar deductions (credits) vary considerably. For example, a family with a combined income of \$55,000, paid over \$3,500 more in income taxes if the income came from one dominant earner than in a similar family with income earned more evenly between the spouses. Other studies have confirmed this bias in the tax system (Boessenkool 1999; Boessenkool and Davies 1998).

Interestingly, a similar phenomenon exists in the business tax system. The amount of taxation levied on corporations can vary considerably depending on the industry and the province in which the firm operates. For instance, prior to the 2000 federal budget, there were different corporate income tax rates applied to manufacturers and processors. Many provinces still maintain this preferential tax treatment. Similar differences among industries and

provinces exist in the taxation of capital. Thus, two firms with similar incomes, profitability, and assets can bear significantly different tax burdens depending on their industry and province of operation.

Vertical equity

The second component of fairness is vertical equity. It is based on the notion that the higher the income people earn, the greater their ability to pay tax. This principle is used to justify the progressive income tax structure in Canada under which, as people earn more, they pay more tax. Table 1 summarizes the 2001 federal statutory personal income tax rates and the thresholds at which they apply.

It is important to note that this tax structure has two effects as incomes increase. First, the average tax rate payable on the total amount of income is raised. Second, there are higher tax rates on additional income beyond the various thresholds.

Recently, the federal and provincial income tax systems have been de-linked in most provinces. As a result, thresholds for marginal tax rates now differ from one jurisdiction to another. Tables 2 and 3 summarize the combined federal and provincial statutory tax rates and the applicable thresholds for the provinces of British Columbia and Alberta. The effect of de-linking can readily be observed in tables 2 and 3. British Columbia now maintains nine statutory tax rates once the federal personal income tax rates are combined

Table 1: Federal Statutory PIT Rates and Thresholds (2001)

Bracket	Interest & Ordinary Income	Capital Gains	Canadian Dividends
\$100,000 & over	29.00%	14.50%	19.58%
\$61,509–\$99,999	26.00%	13.00%	15.83%
\$30,754–\$61,508	22.00%	11.00%	10.83%
\$7,412–\$30,753	16.00%	8.00%	3.33%
\$0–\$7,411	0.00%	0.00%	0.00%

Sources: Federal Department of Finance, Budget 2000 and October Mini-Budget; CIBC / PricewaterhouseCoopers, Statutory Rate Update.

Table 2: Combined Federal-Provincial Statutory PIT Rates and Thresholds (BC)

Bracket	Interest & Ordinary Income	Capital Gains	Canadian Dividends
\$100,000 & over	45.70%	22.85%	33.08%
\$85,000–\$99,999	42.70%	21.35%	29.33%
\$70,000–\$84,999	41.70%	20.85%	28.08%
\$61,509–\$69,999	39.70%	19.85%	25.58%
\$60,969–\$61,508	35.70%	17.85%	20.58%
\$30,754–\$60,968	32.50%	16.25%	16.58%
\$30,484–\$30,753	26.50%	13.25%	9.08%
\$8,000–\$30,483	23.30%	11.65%	5.08%
\$7,412–\$7,999	16.00%	8.00%	3.33%
\$0–\$7,411	0.00%	0.00%	0.00%

Sources: Federal Department of Finance, Budget 2000 and October Mini-Budget; CIBC / PricewaterhouseCoopers, Statutory Rate Update.

Table 3: Combined Federal-Provincial Statutory PIT Rates and Thresholds (AB)

Bracket	Interest & Ordinary Income	Capital Gains	Canadian Dividends
\$100,000 & over	39.00%	19.50%	24.08%
\$61,509–\$99,999	36.00%	18.00%	20.33%
\$30,754–\$61,508	32.00%	16.00%	15.33%
\$12,900–\$30,753	26.00%	13.00%	7.83%
\$7,412–\$12,899	16.00%	8.00%	3.33%
\$0–7,411	0.00%	0.00%	0.00%

Sources: Federal Department of Finance, Budget 2000 and October Mini-Budget; CIBC / PricewaterhouseCoopers, Statutory Rate Update.

with the provincial personal income tax rates. These nine rates are in addition to the exemption value, which is technically an additional statutory tax bracket carrying a rate of 0.0%. Had the previous “tax-on-tax” system been maintained, British Columbia would have only four statutory tax brackets, plus the personal exemption.

A better example of the effect of de-linking on tax brackets is Alberta (table 3). Although the Province of Alberta maintains a single-rate tax, once the federal and provincial personal income tax rates and thresholds are combined, citizens of the province face five statutory tax brackets plus the exemption.

The move towards a “tax-on-income” at the provincial level (de-linking) has given the provinces greater power over tax policy. However, this increased decentralization has come at a price: increased complexity. The current system clearly has more statutory tax brackets, each with increasing marginal rate of taxation.

Economic effects of high and increasing marginal tax rates

The Canadian federal and provincial tax structure just discussed causes economic distortions and inefficiencies due to the disincentive effects of high and increasing marginal tax rates. When people decide to work an additional hour, to increase their human capital through education, or to invest their savings, they consider the marginal tax rate since it directly affects the proportion of increased income that accrues to them after they paid their taxes. The higher the marginal tax rate, the lower the return to productive activity and, thus, the lower the incentive for the individual, family, or business to engage in the additional productive activity.

The folly of demanding higher marginal tax rates for those in the upper income brackets is that higher rates will create disincentives for the most productive members of society to increase their productivity. In so much as this reduces the economic growth that benefits all members of society, increases in marginal tax rates in the long run result cause all of us to be worse off than we might otherwise have been.

The negative economic effects of high and increasing marginal tax rates have been studied widely. Following are brief summaries of some important studies.

Sillamaa and Veall (2001)

This paper used panel data to investigate the effects of the 1988 flattening of marginal tax rates in Canada. The study concluded that the responsiveness of income to changes in marginal taxes is positive, as expected, but smaller in Canada than in the United States. The authors also found evidence of a much higher response in self-employment income and in the labour income of seniors and from those with high incomes.

M. Feldstein (1995)

Using data from the 1986 tax reform in the United States, Feldstein concludes that “a decrease in marginal tax rates causes not only an increase in labour supply (broadly defined), but also a shift in the form of compensation and a reduction in deductible expenses ... Taxable income therefore rises substantially more than aggregate hours.” He also concluded that capital gains realizations are far more sensitive to tax rates than had been assumed by government agencies.

M. Feldstein and D. Feenberg (1995)

This paper assesses the economic effects of increasing the former top statutory tax rate from 31% to 36% and the introduction of a new top rate of 39.6% at \$250,000 in 1993 in the United States. The study concludes that high-income taxpayers would have reported 7.8% more taxable income had the tax rates not been increased. The decline in taxable income for these groups caused the Treasury to lose more than half the extra revenue that would have been collected if taxpayers had not changed their behaviour. In fact, the overall losses in efficiency associated with the higher marginal tax rates (including the effect upon labour supply) was estimated at roughly twice the \$8 billion in revenue raised by the tax increase.

Carroll, Holtz-Eakin, Rider, and Rosen (1998)

Carroll et al. investigated the effects of high marginal tax rates on capital formation. The study found that “a 5 percentage point rise in marginal tax rates would reduce the proportion of entrepreneurs who make new capital investment by 10.4%. Further, such a tax increase would lower mean capital outlays by 9.9%.” In other words,

an increase in marginal tax rates results in less investment by entrepreneurs and subsequently less aggregate capital formation.

Gustavo Ventura (1999)

Ventura concluded that the elimination of taxes on capital, based on a tax reform of the type suggested by Hall and Rabushka, would have a positive effect on capital accumulation and that aggregate labour supply, measured in efficiency units would increase.

Koester and Kormendi (1989)

This study isolated marginal tax effects from average tax effects. They found that, after controlling for average tax rates, increases in marginal tax rates had negative effects on the level of economic activity. In other words, reducing the “progressivity” of the tax system while allowing the government the same tax revenue (measured as a percent of GDP) led to higher levels of national income.

Mullen and Williams (1994)

Mullen and Williams, using methods similar to those employed by Koester and Kormendi (1989), used state-based data in the United States to assess the relationship between marginal tax rates and growth in the capital stock and labour force. They concluded that “lowering marginal tax rates can have a considerable positive impact on growth . . . creating a less confiscatory tax structure, while maintaining the same average level of taxation, enabling sub-national governments to spur economic growth.”

F. Padovano and E. Galli (2001)

This study adjusts the underlying data used in previous studies to specify marginal tax rates properly across income groups and different countries. After doing so, the authors conclude that high marginal tax rates and tax progressivity are negatively correlated with long-run economic growth.

Becsi (1996)

Becsi, again using a method similar to that of Koester and Kormendi (1989), derived marginal tax rates for the American states to assess the relationship between marginal tax rates and economic growth.

He found that differences in marginal tax rates across states have a statistically significant effect on relative economic growth rates.

J. Long (1999)

This study assesses the relationship between marginal tax rates and taxable income across American states. It concludes that an increase in the marginal tax rate reduces taxable income. It also concluded that high-income taxpayers were much more responsive than lower-income individuals to changes in tax rates.

Engen and Skinner (1996)

This study reviewed previously completed research investigating marginal tax rates and economic growth. Engen and Skinner concluded “a major tax reform reducing all marginal rates by 5 percentage points, and average tax rates by 2.5 percentage points, is predicted to increase long term growth rates by between 0.2 and 0.3 percentage points.” While this may appear small, the cumulative effect can be enormous. The authors speculated that, if a less efficient tax structure had been in place in the United States from 1960 to 1996, the amount of output currently lost would have totalled more than \$500 billion annually or 6.4% of 1996 GDP.

Gruber and Saez (2000)

The finding of this study is that for each of the tax-spending cases investigated, the optimal structure of marginal tax rates should be declining as you move up from lower to higher income brackets. In other words, the marginal rates of taxation should be relatively higher for low-income earners and relatively lower for high-income earners. Given the behavioural responses of individuals, the authors conclude that in order to maximize social welfare “the optimal tax system should feature declining (or at least not increasing) marginal rates.”

There can be little doubt that these studies confirm that high and increasing marginal tax rates impede the formation of capital, retard economic growth, hinder per-capita income growth, and constrain aggregate labour supply. This seems a high price to pay for vertical equity and progressivity, which could be achieved with a flat tax.

An advantage of a flat tax is that it can be designed to meet the criteria of horizontal and vertical equity. Horizontal equity is achieved by the inclusion of all sources of income into the base upon which a single or flat rate of taxation is levied. Vertical equity is achieved through the use of a basic personal and spousal exemption of income. Since the flat rate is imposed only on income beyond this exemption threshold, the average tax rate increases with income and approaches the flat rate for the highest income earners. Most important, by eliminating increasing marginal tax rates, a flat tax avoids many, if not all, of the costs outlined in the literature reviewed above, namely, lower economic growth, reduced savings and investment, and lower aggregate labour supply.

Simplicity

The flat tax also brings the benefit of simplicity, which makes it easier and less costly for citizens and business to comply with tax laws. The increased simplicity would bring large savings since the complexity of the tax code and the many tax forms and regulations in Canada have spurred an entire industry of tax accountants, lawyers, and planners who do nothing but attempt to reduce their clients' tax bills legally. Much of this industry would disappear if a flat tax were adopted and the resources in the industry would find employment in other industries meeting the genuine needs of Canadians.

The administrative and compliance costs associated with business taxes have been estimated by Robert E. Plamondon and David Zussman (1998). They found the cost to be between \$2.3 billion and \$4.5 billion in 1996. The midpoint of this range is \$3.4 billion, which represented $\frac{2}{5}$ of 1% of GDP or 1.5% of total tax revenue in 1996.

Two studies completed by Professor Brian Erard of Carleton University for the Technical Committee on Business Taxation (otherwise referred to as the "Mintz Commission") provide estimates of business compliance costs that buttress the estimates of Plamondon and Zussman. One of Erard's studies showed that the burden for the 500 largest non-financial corporations in Canada in 1995 was \$250 million, or about 5% of total taxes paid (Erard 1997a).

Professor Erard's second study for the Mintz Commission confirmed that many small and medium-sized businesses feel overwhelmed by the compliance requirements associated with Canadian taxation. In fact, the central finding of the study was that the

vast majority of small and medium-sized enterprises relied on outside professional assistance to comply with the tax system and that the principal compliance cost identified by these businesses were fees paid to these professionals (Erard 1997b).

There also exist estimates of the administrative and compliance costs of taxation for individuals. In a major study for the Canadian Tax Foundation, Francois Vaillancourt (1989) estimated that for the 1985 tax year, the average taxpayer spent 5.5 hours completing tax returns or spent roughly \$69 (1985 dollars) to have a professional do the job. He then included other related costs to arrive at a total cost per taxpayer of \$117.20 (1985 dollars) in administrative and compliance costs. This translates into roughly \$1.8 billion in administrative and compliance costs for 1985 for individual taxpayers. Although somewhat dated, the study provides an important foundation for understanding the extent of costs associated with the personal income tax system.

Finally, there is cost of collection by government. The Fraser Institute recently estimated that the federal government alone spent some \$2.6 billion in 1997/1998 to collect taxes and other revenues (Jones and Graf 2001).

The simplification of the tax system is a central part of flat tax reform. The simplification is achieved by the removal of most exemptions and nearly all deductions and tax credits and through the elimination of different treatment of income by type. As a result of the latter provision, there is no benefit in declaring income as one type or another since all income is taxed once and at the same rate.

2 The Hall-Rabushka Model

The tax reform proposed by Professors Robert E. Hall and Alvin Rabushka of the Hoover Institution is based on the use of a single rate of taxation for all sources of income. This proposal represents a fundamental change from the way governments currently collect tax revenue. The proposal achieves simplicity, economic efficiency, and fairness, the traditional measures of effective taxation, while collecting the necessary revenues required to finance government operations. Those wishing to study the proposals of Hall and Rabushka in greater detail will find their works on the Internet at the Hoover

Institution (www.hoover.org) and the American Enterprise Institute (www.aei.org) as well as in their book (Hall and Rabushka 1995), which will be found in most major bookstores and libraries.

The flat tax differs from the single-rate tax

The reforms to the personal income tax announced in the Province of Alberta in 1999 replaced the multiple tax rates applied to personal income with a single tax rate, thus eliminating the progressivity in the personal income tax structure that existed previously. The tax reform proposed by the Canadian Alliance during the federal election campaign in 2000 would initially replace the multiple federal statutory personal income tax rates with two rates, retaining some of the higher marginal tax rates as a function of income. The Alliance's proposal envisaged that, near the end of the party's first mandate, the two rates would be replaced by one, along the lines of Alberta's single-rate tax system. However, the replacement of multiple tax rates with a single rate is but one step in the process of broad-based tax reform based on a flat tax model.

Hall-Rabushka flat tax

Under the current tax system in both the United States and in Canada, certain types of income, such as some fringe benefits, are not taxed at all while other sources of income, such as dividends and capital gains, are taxed more than once. Under the reform proposed by Hall and Rabushka, all sources of income would be taxed only once and at one uniform rate.

Under the present system in the two countries, there exists an additional problem. Different sources of income are often taxed at different rates. This is the case for income from dividends, wages and benefits. Under the Hall-Rabushka proposal, all sources of income would be taxed at the same rate.

Hall and Rabushka argue that the imposition in the United States of a federal rate of flat tax of 19% on all sources of income would raise the same amount of revenue as the current system, which has 5 personal federal rates (15%, 28%, 31%, 36%, and 39.6%) and a number of business tax rates. They proposed that the 19% rate of taxation be payable only after generous personal exemptions, which for a family of four in 1995 would have been US\$25,500 (CDN\$32,986). These exemptions mean that a family with income

below \$25,000 pays no tax whatsoever. Those with incomes above \$25,000 pay 19% on the income in excess of the exemption.

It is important to note that under the Hall-Rabushka proposal only wages, salaries and pension benefits are subject to personal income tax. Dividends, capital gains, interest, and fringe benefits are not included in the personal income tax base because they are subject to taxation under the corporate income tax.

One frequently overlooked aspect of Hall-Rabushka is its rejection of alternative taxes such as a national sales tax or a value-added tax to replace revenue lost from the elimination of multiple taxation and the adoption of uniform rates on all incomes. They reject the alternative taxes because they make it impossible or extremely costly to exempt lower-income individuals and families from taxation, as is done under their proposal through the use of the generous basic exemptions.

The Hall-Rabushka flat tax would also allow “postcard-size tax returns”: individuals and families would simply sum their income from wages, salaries, and retirement benefits and subtract the personal exemption to calculate their taxable income. This amount is then multiplied by one rate (19%) to determine the individual or family tax bill for the year. The amount withheld is then compared to the amount owed to calculate whether a refund is due from, or a payment is owing to, the federal government. All of this information could easily fit on a post card. One of the main reasons that the tax return under the Hall-Rabushka system is so short and simple is that there are no opportunities to adjust the income base of the tax payable for tax credits, deductions, or additional exemptions and the type of income, which makes the present tax returns so complicated and time-consuming to prepare.

Another important aspect of the Hall-Rabushka proposal and, indeed, most flat-tax proposals, is the reform of the corporate or business income tax. According to their proposal, the tax base for business equals all business income minus the cost of inputs, salaries, wages, pensions, and investment in plant and equipment. The tax base is broadened through the elimination of tax-based incentives for business, the taxation of certain benefits that currently escape taxation, and by removing interest deductibility. As a result, they are able to maintain revenue neutrality in spite of the lower uniform tax rate of 19%.

Under the proposed system, businesses cannot deduct the cost of interest, dividends, fringe benefits, or any other payments to owners as expenses, as they do under the present system. This aspect of the Hall-Rebushka reform of business taxes is seen as quite radical by many. But, it is necessary to assure that these payments to individuals are taxed at the source and, under the principle of taxing income only once, do not have to be reported as taxable income by individuals receiving them. The proposed reform of business taxation, under which interest costs and depreciation expenses are no longer considered to be deductible expenses, brings another important benefit. It eliminates the present preferential treatment accorded debt relative to equity financing.

Perhaps the single most important and controversial proposal for the reform of business taxation made by Hall and Rabushka is the elimination of depreciation expenses. Businesses are currently able to write-off or deduct from pre-tax income the cost of investing in new plants and equipment on an incremental basis. The amount deductible every year is a percentage of the cost, which is a function of the economic life of the investment and is specified by the tax authorities. Hall and Rabushka propose that the entire cost of the investment is deductible as an expense in the year of purchase. There would then be no conflicts over whether the purchase of a certain piece of equipment is an investment and therefore subject to depreciation or if it is an expense and eligible to be written off in the year it is incurred. Depreciation schedules and the bureaucracy required to interpret them (accountants and lawyers) and to enforce them (government revenue officials) are eliminated or, at least, drastically reduced in number.

Focus on consumption

One of the main, though often overlooked, benefits of the Hall-Rabushka proposal is that it effectively moves personal and business taxation from an income base towards a consumption base. Economists generally agree that the taxation of consumption is the most efficient manner in which to raise tax revenue (Jorgensen and Yun 1991; Kesselman 1997; Grubel 2000; OECD 1997; and Kneller, Bleaney, and Gemmell 1999). Hall and Rabushka achieve this goal by excluding all investment activities from the tax base² and, thus, taxing only income that is consumed, that is, spent rather than

saved. In addition, the Hall-Rabushka reform would also eliminate the present heavy taxation of returns to savings, which would create highly desirable incentives for increased savings and the formation of capital.

Economic considerations

From an economic perspective, the most important benefits of the Hall-Rabushka tax reform proposals are their creation of improved incentives for work, increased entrepreneurial activity, and greater formation of capital, which will lead to higher levels of national output and a higher standard of living. These economic benefits, in the longer run, are almost certain to be more important than the immediate and more obvious savings from the simplification of the system of taxation that will accrue to taxpayers directly and, through reduced government costs, indirectly.

In addition, some of the specific tax reforms proposed by Hall and Rabushka will lead to increases in the efficiency of capital formation through the elimination of the present tax-based incentives in the form of tax credits and subsidies that tend to redirect capital to less efficient uses. For example, the current system promotes debt-financed investment by permitting interest deductibility while penalizing equity-financed investment through double taxation of dividends and capital gains. The net result is less entrepreneurial activity and greater debt-financed (lower risk) investment. Auerbach and Kotlikoff (1987; cited in Hall-Rabushka) estimate that a flat tax would increase capital formation as a percent of GDP from 5.0% to 6.2% and, as a consequence, increase GDP by between 2.0% and 4.0% within seven years.

The Hall-Rabushka reform proposal also creates strong incentives for individuals to increase their work effort by reducing the disincentive effects associated with high and increasing marginal tax rates. Hall and Rabushka estimate that GDP will increase by approximately 3% simply due to the proposed elimination of disincentives for work.

The preceding summary hardly does justice to the wide ranging and comprehensive tax reforms proposed by Hall and Rabushka. However, our brief summary is sufficient to show that the proposals offer far-reaching economic benefits through significant increases in the simplicity, efficiency, and fairness in the tax system.

3 What would a flat tax look like in Canada?

We used Statistics Canada's Social Policy Simulation Database and Model (SPSD/M) to quantify the changes in tax rates that would arise from the application in Canada of the principles of the personal income tax reform proposed by Hall and Rabushka. We calculated what would happen to the income tax obligations of Canadians after the introduction of a flat tax under nine different scenarios. Unfortunately, we were not able to calculate integrated personal and business income estimates because of limitations in the data found in the SPSPD/M. For this reason, it is important to remember that our results are not strictly comparable to those of Hall and Rabushka, since their model reforms both personal and business income taxes.

Table 4 shows the results of our calculations. The first seven analyses are for flat tax rates that preserve the present revenues under different assumptions about the level of exemptions, the retention of RRSP/RPP contributions, and deductions for charitable contributions. The remaining two calculations provide less tax revenue than is currently collected; in other words, there is a reduction in taxes.³

There are several important observations to be gleaned from table 4. First, assuming a simplified system with only personal and spousal exemptions, and child deductions, the federal flat tax rate required to raise the same amount of revenues as the current system is 18.3% with a provincial average rate of 10.3% (Scenario 5). This implies an average personal income tax rate of 28.6%. The result is that all income groups earning above \$50,000 receive a tax reduction while those earning between \$10,000 and \$50,000 experience a marginal increase. (Clemens and Emes 2001 contains tables outlining the distributional effects of such a change.)

Scenario 6 considers the effect of including (retaining) RRSP and RPP deductibility, which effectively creates a consumption-based tax system. The flat rate rates required to raise the same amount of revenue as is currently collected are 19.9% at the federal level and 11.1% at the provincial level (average rate). This results in a combined federal-provincial flat tax rate of 31.0%, an increase of 2.4 percentage-points or roughly 8.4% over the flat tax rate in scenario 5. Distributional analyses in Clemens and Emes 2001 show

that those earning in excess of \$50,000 a year experience a net reduction in their taxes while those earning between \$10,000 and \$50,000 experience a marginal increase in their taxes. It is important to note that the inclusion of an RRSP/RPP deduction represents a tax deferral rather than a current tax expenditure, implying that the long-term tax revenue collection of the government would not be affected (see ACPM 2000).

Increasing the basic and spousal exemptions, as presented in Scenarios 8 and 9, results in a decrease across the board in personal income taxes paid for all income groups. Both cases represent a fairly simple system—basic and spousal exemption of \$11,834, child exemption of \$2,000, and current RRSP/RPP deductibility—but are coupled with tax and expenditure reductions at the federal level. In other words, the increase in the basic and spousal exemptions are financed through a moderate (scenario 8) and a substantial (scenario 9) tax and expenditure reduction.

As suggested by Hall and Rabushka, the system should remain as “clean” as possible, avoiding the introduction of additional exemptions, deductions, and tax credits. In particular, they caution against making exceptions for specific programs or requirements since such initiatives are seen as the beginning of a slippery slope to a complex, inefficient, and unfair tax system (See the discussion of scenario 7 in Clemens and Emes 2001 for more details and a discussion of this topic).

Competitive advantages of a flat tax

Canada is currently searching for ways to make its economy more competitive with that of the United States. The federal tax reductions enacted in 2000 were officially justified on these grounds by the Minister of Finance in the 2000 Budget speech. Unfortunately, the Canadian government has ignored the possibility of creating a competitive tax advantage over the United States through the overhaul of the tax system. The simplification of the tax system made possible by the introduction of a flat tax would give Canada an immediate and substantial competitive advantage. Currently, there are some 740 different tax forms in the United States with 250 or so publications explaining the forms. The US Tax Foundation estimates that Americans spend about 4.3 billion hours a year filling tax forms at a cost to the economy of \$125 billion. Some tax

**Table 4: Flat Tax Rates for Canada and the Provinces**

Scenario	Personal Exemption	Child Exemption	Change in Revenue Collected ¹	Deduction for RRSPs and RPPs ²
1	\$0	\$0	\$0	
2	\$7,231	\$0	\$0	
3	\$8,766	\$0	\$0	
4	\$17,532	\$0	\$0	
5	\$8,766	\$2,000	\$0	
6	\$8,766	\$2,000	\$0	√
7	\$8,766	\$2,000	\$0	√
8	\$11,834	\$2,000	-\$13.4	√
9	\$11,834	\$2,000	-\$22.4	√

(1) Refers to the Federal Government only. Any change in the amount of revenue collected implies an expenditure and tax reduction at the federal level only. Stated in billions of dollars.

(2) RRSP/RPP contributions and charitable donations, if present, are treated as they currently exist in the federal tax system.

reform proposals introduced in Congress envision the creation of new income tax brackets with different marginal tax rates, which would make the American system even more complex. The present and possibly increasing complexity of the American tax system provide Canada with a unique opportunity to establish a real economic advantage over our neighbour. The adoption of a flat tax based on the Hall-Rabushka model would make Canada's system much simpler and at the same time more efficient while retaining most of its horizontal and vertical equity. The economic advantage gained by Canada through such a tax reform in the longer run would allow the country to narrow the gap in real per-capita income that has developed during the last 25 years.

Deduction for Charitable Donations ²	Federal Flat-Tax Rate	Average Provincial Flat-Tax Rate	Ontario Provincial Flat-Tax Rate ³
	12.7	7.0	5.8
	16.7	9.4	7.5
	17.8	10.0	7.9
	26.1	14.8	11.2
	18.3	10.3	8.1
	19.9	11.1	8.8
√	20.1	11.2	8.9
	19.0	12.9	10.0
	16.5	12.9	10.0

(3) Presented for illustrative purposes only.

Note: Distributional analysis of the scenarios are available in the main paper, available on the Internet at www.fraserinstitute.ca.

Source: Emes and Clemens, 2001.

Conclusion

The flat tax offers Canada the opportunity to adopt a fair, efficient, and simple tax system. Such a system would provide large positive incentives for work, savings, investment, and risk-taking. Empirical evidence suggests that the direct savings and economic benefits over the longer run of implementing a flat tax system would raise Canada's rate of economic growth, which in turn would lead to higher per-capita incomes and make affordable higher levels of government spending on social programs.

Notes

- 1** Rodger Scott was a Fiscal Studies Intern in 2001 and aided in the updating of the study. Both authors wish to express their thanks to Rodger for his efforts and contributions to the Fiscal Studies Department.
- 2** Poddar and English (1999) estimate that, in the current Canadian tax system, 75% of domestic savings are tax exempt (1999). This is due to the fact that the overwhelming majority of Canadians save exclusively within the confines of Registered Retirement Savings Plans (RRSPs) and Registered Pension Plans (RPPs). Thus, the inclusion of an RRSP/RPP deduction within a flat tax system would essentially mirror a national consumption tax or move considerably towards one.
- 3** Readers interested in more detail about the different assumptions and results can find them in our paper (Clemens and Emes 2001), which is available on the Internet at www.fraserinstitute.ca.

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