

## Flat tax: fairer or foul?

Burden would move from wealthy to middle-income earners

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Proponents of the flat tax attribute miracle properties to the proposal claiming a flat tax will: curtail misallocation of expenditures; end tax evasion (for example, the underground economy); increase work effort, savings and investment; turn around the brain drain; reduce taxes; simplify taxes; increase fairness; and, in general, solve the ills of a modern complex society. Each of these claims will be considered in order.

Governments are responsible to spend citizens' tax revenue in an efficient and appropriate manner. They sometimes fail this responsibility through error, and less frequently (luckily in Canada at least), through graft. But the way in which tax revenues are obtained is independent of how the funds are deployed. Citizens need to be vigilant -- it is absurd to argue that a flat tax will solve irresponsible spending.

Tax avoidance is the legal effort to minimize one's tax through sanctioned income exemptions. Tax evasion is a crime (and those who pay cash under-the-table are an accessory to crime), and it hurts all of us through higher tax rates and policing costs. A flat tax will not end this criminal behaviour. What is needed is increased effort in enforcement.

It is true that income performs incentive functions, so taxation policy has to be concerned with the effect on effort and achievement. However, the argument that a flat tax will increase work effort, personal savings, and investment, is pure political rhetoric. Simply put, it's true that some people may work more, or save and

invest more if taxes go down because they value more goods now and in the future over leisure. However, it is also true that some people may work less, or save and invest less if taxes go down because it is easier to attain a desired amount of wealth. The research evidence suggests that decisions about work hours, saving and investment are neutral to changes in tax rates.

Do taxes really attract or repel business and people? The brain drain, to the degree that it exists, is likely more to do with the higher salaries available for similar jobs in the U.S., a more attractive climate, or other reasons. Many variables bear on an individual's decision where to locate. Certainly, jobs, educational opportunities and good health care are likely more important than the tax regime.

The proposed flat tax systems (already implemented in Alberta) do include major

tax reductions. Of course, reducing taxes can be accomplished with any tax regime just by lowering the tax rates, increasing the income exemptions, or moving the brackets as Finance Minister Paul Martin has recently done.

The clear agenda behind a flat tax is to shift the tax burden down. For example, for any \$1 of revenue, a flat tax will place higher taxes on the middle and lower income groups and lower taxes on the higher income groups than the current tax system in place.

Arguments for tax simplicity and ease of administration are attractive. The current federal tax act is a huge, complex and often indecipherable piece of work. Many people agree that the tax code needs simplifying. However, simplicity is not inherent in a flat tax. The complexity of the tax system lies in the calculation of taxable income.

A simple alternative to the reactionary flat tax is eliminating the complexity of the tax act. Currently there are hundreds of examples of tax-preferred income.

However, it should be kept in mind that the tax code is used as a means to accomplish a number of economic policy directions that may be desirable, therefore the case for an increased tax base is more controversial than it at first appears.

For example, child credits help support those with dependent children. RRSP deductions support individuals in providing themselves reasonable incomes in their retirement years, reducing or eliminating the burden of the aged on society. RESPs support the provision of savings for the higher education of our children. Tax incentives through exemptions to taxable income can assist Canadian investments.

Ultimately, the test of a tax regime is fairness. A change to a flat tax moves the overall tax burden from the wealthier to the middle-income with lower incomes benefiting only if the personal income exemption is significantly increased.

Advocates of a flat, or proportional, tax suggest fairness is achieved by having everyone subject to the same tax rate, bearing the tax burden proportionally. A flat tax does not change before- tax income distribution. Some consider this fair because they believe markets distribute income based on how hard people work, save and invest. Although a flat tax does not eliminate the opportunity to redistribute income, it does eliminate the automatic redistributive aspects of a more progressive income tax.

In contrast, the support for progressive taxation emphasizes different individual circumstances suggesting that ability to pay is what is most important. Poor people should be exempt from tax while the rest should contribute a greater percentage to taxes as income rises. After-tax income is more equal under a progressive tax system, helping restrict concentration of economic and political

power.

These differences of opinion on fairness revolve around a person's sense of whether an individual is "self made" through their own sole effort or alternatively that one is "in it all together" doing well as a community. Income depends not only on individual effort but also on the individual's social circumstances, random accidents of birth, acts of God, and economic and historical events. It is this random distribution of personal attributes and wealth that leads to unequal incomes. What is the justice in this?

At least as far back as Adam Smith's landmark *Wealth of Nations* (1776), the economics discipline has emphasized progressive taxation with its implicit understanding that the tax burden should fall on those most able to pay. Those with the greatest ability to pay -- high-income earners -- realize the largest benefits from the economic system, both economic and political. They should, therefore, be expected to contribute to the public revenue more than proportionally to their income. In light of this, a progressive income tax seems practical and reasonable, especially in a democratic society.

[Illustration]

Graphic: (The illustration shows a person climbing a ladder that is missing rungs above the caption, "Grad tax".) ;

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