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## Flattening the Claims of the Flat Taxers

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# Articles

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Neil Brooks\*

Flattening the Claims of the  
Flat Taxers

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*The idea that income tax rate brackets should be flattened has gained some support among neoclassical economists, right-wing think-tanks and Canadian politicians. Those propounding the idea argue that flattening the rate structure will simplify the tax system and reduce tax avoidance and evasion. They also argue that it would usher in an era of increased economic prosperity by encouraging talented Canadians to work harder, save and invest more, and remain in Canada. In defending progressive taxation, this article takes issue with each of these claims. It concludes that the fundamental differences between those who support flat taxes and those who support progressive tax rates are their respective views about the ethical justification for the market distribution of income and the need for a relatively equal distribution of economic resources to sustain a vibrant democratic and civic society.*

*L'idée que les tranches de taux d'imposition sur le revenu doivent être aplanies a gagné un certain appui parmi les économistes néoclassiques, les cellules de réflexion de droite, et les politiciens canadiens. Ceux qui proposent cette idée argumentent qu'en aplanissant la structure des taux d'imposition le système de taxation serait simplifié et l'évasion et la fraude fiscale seraient réduites. Ils ajoutent que cela entraînerait une nouvelle époque de prospérité économique en encourageant les Canadiens doués à travailler plus fort, d'épargner et investir d'avantage ainsi qu'à demeurer au Canada. En défendant la taxation progressive, cet article traite de chacun de ces prétentions. L'auteur conclut que la différence fondamentale entre ceux qui appuient l'aplanissement des taux d'imposition et ceux qui appuient des taux de taxation progressifs est basée sur leurs opinions respectives concernant la justification éthique quant à la distribution des revenus du marché et la nécessité d'une distribution relativement égale des ressources économiques pour permettre le maintien d'une société civique, démocratique et vibrante.*

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\* Neil Brooks teaches tax law and policy at Osgoode Hall Law School. This is an expanded version of the 1997 annual Horace Read Lecture. I would like to thank my colleague Reuben Hasson for his always helpful comments and Patrick Smith for his indefatigable research assistance.

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### *Introduction*

The idea that income tax rate brackets should be flattened has gained some support among Canadian politicians. Those propounding the idea argue that flattening the rate structure would simplify the tax system and reduce tax avoidance and evasion. Most importantly, they argue that it would usher in an era of increased economic prosperity by encouraging talented Canadians to work harder, save and invest more, and remain in Canada. In defending progressive taxation, this article takes issue with each of these claims. It concludes that very likely the fundamental differences between those who support flat taxes and those who support progressive tax rates are their respective views about the ethical justification for the market distribution of income and the need for a relatively equal distribution of economic resources to sustain a vibrant democratic and civic society.

#### *I. Explaining The Enigmatic Attraction of Flat Taxes*

It is a great pleasure to be invited to give the Read lecture. Like so many others, I have long been an admirer of legal education at Dalhousie. Horace Read was, of course, Dalhousie's first Dean who was also a professional law teacher and he is widely recognized as being one of the founders of modern legal education in Canada. Further to his credit, it was under his Deanship that taxation was introduced as a serious subject of study at Dalhousie. In 1959 he hired Ed Harris to be the first full-time faculty member to teach tax law. Before that time, tax law was regarded as 'too practical' to be considered an academic subject. The other slightly less tenuous connection the subject matter of my remarks have to Dean Read's legal contributions is that he had a passionate scholarly interest in legislation and the legislative process. Tax law is entirely statutory - in origin, in design and in substance. No principle of common law holds that everyone must turn a portion of their earnings over to the state. However, having made those connections between Dean Read and the subject matter of my talk, I rather suspect that he would not agree with very much of what I am going to say, but in that regard he would no doubt be in good company.

The title to this lecture discloses its general tenor. Other possible titles might include: "The Flaky Tax," "The Flat Tax Scam," "Flat Taxer's Flat Deceptions," "With Income Tax, 'Flattery' Will Get You Nowhere," "The Flat Tax Society," "Flat Taxes for Fat Cats," or "Deflating the Flat Tax." Unfortunately, some of these titles have been claimed by fellow-travellers more imaginative than I. Although this point might seem obvious by now, to fully reveal my theoretical and ideological hand, I am

not in favour of flat taxes. Further, I think the progressivity of our present tax system should be greatly increased. Indeed, I have tried to make a career out of one fairly straightforward idea - namely that the rich and large corporations ought to pay their fair share of tax.<sup>1</sup> My career has not been all that successful, in fact, it has been a total failure. The rich and large corporations continue to make out like bandits through the tax system.

I would like so much to make the rich pay that it sometimes embarrasses me to have to tell people I am a tax lawyer. Almost by definition, the sole role of tax lawyers is to serve the rich and large corporations. By way of apology, I am always quick to point out that I do not actually practice tax law, I only teach it. But frankly, it has never been clear to me which profession has less social value. Teaching students tax law, knowing that at least some of them are going to go down to Bay Street and use the skills and knowledge they learn in my courses to help the rich pay even less tax, used to cause me a good deal of anxiety. Once when I was lamenting to one of my classes the consternation this disjuncture in my life caused me, some student at the back of the room rose and said that if it was any consolation to me, I was not doing a very good job of it. That made me feel a whole lot better about myself and my job in the university.

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1. I do have a philosophy as to why the rich should be made to pay their fair share of tax, however, to be frank, my firm belief is likely accounted for, in part, because I remain an unrepentant product of the 1960s. If a person who went to university during that decade is to remain faithful to their generational roots, wanting to make the rich pay their fair share would appear obligatory. Since the 1960s the idea has not had much currency; however, there is now a Web site in the United States at which one can join the TAX THE RICH cause and even become part of a nationwide saturation poster campaign by ordering posters proclaiming "Is any man worth 3,000 nurses?" or "Lower the maximum wage." See the United for a Fair Economy site at [<http://www.stw.org/taxtherich/contents.html>].

Parenthetically, in urging that the rich should pay their fair share of tax, I cannot recall how many times I have been accused of attempting to start a class war, among other less kindly accusations. This is a common strategy of those who would defend the privilege of great wealth and power. It was with some comfort that I recently noticed that even the Treasury Secretary of the United States has been so accused. Last year Treasury Secretary Lawrence Summers suggested in testimony before a congressional committee that those who were pushing for a cut in the estate tax were motivated by "selfishness." He was bitterly attacked in Congress and the popular press for promoting "class warfare." Even though his assertions seems uncontentious, he was forced to apologize. See M. Cottle, "The Real Class War: When it Comes to Taxes, It's the Rich Against the Rest of Us" *The Washington Monthly* (July/August 1997) 12. This is so silly. Why is it class warfare to argue that the rich should pay more tax, but it is not to argue that they should pay less? Further, anyone who doubts that there is a class war going on has not been following government policy over the past couple of decades and, in spite of rising economic growth, the rising increase in poverty rates and income and wealth inequality. See for example R. Ellsworth, "Squandering Our Inheritance: Re-Forming the Canadian Welfare State in the 1990s" (1997) 12 *J.L. & Soc. Pol'y* 259. All those who want to make the rich pay their fair share of tax want to do is turn the battle around a little bit.

The idea of a flat tax has attracted a good deal of political attention. It has been a major item on the political agenda both in Canada and the United States on a number of occasions over the past two decades. As Canadians discuss what to do with the so-called fiscal dividend, now that the Federal government appears to have vastly overshot its deficit targets, the flat taxers will undoubtedly once again be out in force arguing, in effect, that it would be in the best interests of everyone if individual greed was completely liberated and democratic decision-making was further constrained by reducing the progressivity of the tax system. Many interest groups and most of the leading newspapers appear to be in favour of a major tax cut. If past experience is any indication, the Reform and Progressive Conservative parties, business interests, major right-wing think-tanks, and others who generally represent the interests of the rich and powerful in public debate, will attempt to hijack this tax cut movement to push for flatter tax rates.

On its face, the political attraction of the idea of flat taxes is somewhat of a mystery. After all, as Joel Slemrod and Jon Bakija have noted,<sup>2</sup> in most contexts the word flat does not connote a good thing: think of beer, or music, or a tire, or a joke that falls flat, or a market that remains flat. Sometimes flat is used to suggest something that has lost the value it once had: a movie that was widely admired in the 1960s might seem flat today. An author's portrayal of flat characters is often taken to betray evidence of a shallow mind. Moreover, there is no question that flattening the income tax rates would increase the taxes paid by the middle class. If a flat tax reduces the rates paid by the rich, and exempts the very poor (as most flat tax proposals do), the relative percentage of taxes paid by the middle class must go up, even if taxes are reduced. This is elementary mathematics.

Flat taxes appear to have political appeal only because flat taxers misleadingly conflate the case for flat taxes with the case for broadening the tax base, reducing taxes, simplifying the tax system, and closing loopholes ostensibly so that the rich pay at least some tax. In all these respects, the rhetorical appeal of flat taxes is misleading. In selling flat taxes as if it were a populist idea that deserves the support of the middle-class, and in attempting to capitalize on populist discontent with the tax system, flat taxers are being deceitful. I will return to this point. Of course it remains to be seen whether the idea of a flat tax can gain so much popular support that it will be enacted. In the past, when the idea of

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2. J. Slemrod & J. Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform* (Cambridge: MIT Press, 1996) at 161.

enacting a flat tax has taken centre stage as a political issue it has initially excited great attention but then has relatively quickly faded from political view. Perhaps this is an indication that people are not as easily fooled as the tax flatteners would believe. Once the public realizes the perverse distributional consequences of abandoning progressive tax rates, even the promises that they will be able to file their income tax return on a post card or that reduced taxes on the rich will lead to a burst of economic activity do not look so attractive.

## II. *Examining the Origins of the Idea of Flat Taxes and Recent Incarnations*

### 1. *The Mean-Spirited Assault on Progressivity*

Over the past two decades, governments of a number of industrialized countries have attempted a political initiative unique in this century - a sustained and deliberate redistribution of income from the poor and the middle-class to the rich. The frontal assault on the welfare state began in the United Kingdom and the United States, where it was referred to as Thatcherism and Reaganism; however, the program to make the rich richer has been apparent in many other industrialized countries, including Canada. The ideological basis for this fundamental redirection in policy is neoconservatism or the new right.<sup>3</sup>

The basic thrust of this agenda has been to marginalize the political system and to concentrate power in the private sector where it can be exercised free from any serious constraint by those with significant economic resources. To achieve this end, every policy instrument that citizens use to achieve their collective goals through democratic institutions has been maligned and stunted: state enterprises and even social services have been privatized, industrial and financial sectors have been deregulated; environmental and consumer regulations abandoned, social security programs have been reduced, and union power has been curbed. However, one of the most mean-spirited forms this attack on democratic institutions has taken has been the attempt to reduce the progressivity of the tax system. It is no surprise that taxes, and in particular the progressive income tax, would bear the brunt of the assault by the new right. Taxes

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3. Books on neoconservatism and the implementation of the corporate agenda in Canada are legion. Recent popular studies include M. Dobbin, *The Myth of the Good Corporate Citizen: Democracy Under the Rule of Big Business* (Toronto: Stoddart, 1998); L. McQuaig, *The Cult of Impotence: Selling the Myth of Powerlessness in the Global Economy* (Toronto: Penguin, 1998); and J. McMurtry, *Unequal Freedoms: The Global Market as an Ethical System* (Toronto: Garamond Press, 1998).

make possible many of the programs that provide economic security to workers and citizens with low incomes. Moreover, tax policy is quintessentially a matter of class politics, and progressive tax rates are, at least symbolically, a minor victory for the masses.<sup>4</sup> The flat tax movement is simply the culmination of this attack on taxes and progressive rates.

## 2. *Flat Taxes in the United States: One More Time, With Feeling*

Like many public policies designed to increase inequalities, the flat tax originated in the United States. Although the debate over proportionality versus progressive taxes raged in the United States for over 50 years prior to the passage of the Sixteenth Amendment in 1913, which authorized the passage of a federal income tax with progressive rates,<sup>5</sup> during most of this century, at least until the last couple of decades, the idea of progressive tax rates was widely accepted and remained relatively unquestioned. But while there was a general consensus on the desirability of progressivity during this period, there was also an undercurrent of opposition from the libertarians. Frederick Hayek and Milton Friedman at the University of Chicago and Ludwig von Mises all wrote strong critiques of progressive taxation, and called for a flat-rate tax.<sup>6</sup> The most influential attack on progressive rates during this period, and the one that Hayek attributes to re-opening the debate,<sup>7</sup> was Walter Blum and Harry Kalven's masterful and lucid book, *The Uneasy Case for Progressive Taxation*.<sup>8</sup> Although they called their book the "uneasy case" for progressive taxation, which might be taken to imply there is a case but it is difficult, they in fact did

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4. For an extended discussion of the ideas suggested in this paragraph see N. Brooks, "The Changing Structure of the Canadian Tax System: Accommodating the Rich" (1993) 31 *Osgoode Hall L.J.* 137.

5. S.A. Bank, "Origins of a Flat Tax" (1996) 73 *Denv. U.L. Rev.* 329.

6. See M. Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962) at 174 ("All things considered, the personal income tax structure that seems to me best is a flat-rate tax on income above an exemption, with income defined very broadly and deductions allowed only for strictly defined expenses of earning income."); F.A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960) at 322 ("If a reasonable system of taxation is to be achieved, people must recognize as a principle that the majority which determines what the total amount of taxation should be must also bear it at the maximum rate."); L. von Mises, *Human Action: A Treatise on Economics* (New Haven: Yale University Press, 1949) at 803 ("It is very different for 90 percent of the population to vote taxes on themselves and an exemption of 10 percent than for 90 percent to vote punitive taxes on the other 10 percent. . . . If a reasonable system of taxation is to be achieved, people must recognize as a principle that the majority which determines what the total amount of taxation should be must also bear it at the maximum rate.").

7. Hayek, *ibid.* at 516.

8. W.J. Blum & H. Kalven Jr., *The Uneasy Case for Progressive Taxation* (Chicago: University of Chicago Press, 1953).



not support progressivity. In addition to the slightly misleading title, their book is written with such apparent courtesy, caution and objectivity that their conclusion is sometimes overlooked by liberals who frequently refer to the book approvingly.<sup>9</sup>

Blum and Kalven's preferred tax structure was a flat rate with a basic exemption - they called it a degressive tax.<sup>10</sup> Over the years, Blum has reconsidered the conclusion of his and Kalven's monograph, and on each occasion has restated it with greater conviction. In 1976 he re-considered the "uneasy case" for progressivity in light of the apparent consensus that the state should provide everyone with a minimum standard of living.<sup>11</sup> To some people, the rise of the welfare state was making the case for progression less uneasy. Moreover, there appeared to be increasing support for the notion that redistribution was a proper goal of taxation for a variety of political reasons including the perceived link between economic power and political power, and an alleged relationship between affluence and poverty. To this line of argument, Blum had sharp rejoinders: "The affluent do not have the economic power or means or motivation to prevent individuals from rising above poverty."<sup>12</sup> Moreover, a plan that taxes the rich in order to provide for the poor could, he claimed, alter the character of society itself by changing the meaning of private property. Whereas it had long been held that "a person is entitled to his property but the government may take from him an amount that is thought to be a fair sharing of the cost of discharging public functions," according to Blum the message of steep progression as a tool to transfer wealth to the poor, "seems to be that an individual is entitled to keep only that portion of his resources which the government decides not to take for

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9. One wonders to what extent this book was part of the political agenda at Chicago. It was started shortly after Hayek's libertarian call to arms: "Unless we can make the philosophic foundations of a free society once more a living intellectual issue, and its implementation a task which challenges the ingenuity and imagination of our liveliest minds, the prospects of freedom are indeed dark." F.A. Hayek, "The Intellectuals and Socialism" (1948-49) 16 U. Chi. L. Rev. 417 at 433. Apparently Aaron Director did much to stimulate the researchers, see Blum and Kalven, *supra* note 8 at viii. Also, as a matter of interest, it was warmly reviewed by John Chamberlain, who had written the introduction to the American edition of Hayek's *The Road to Serfdom* and who personally viewed progressive taxation as legalized theft. He enthused that Blum and Kalven's book had conferred "academic recognition" on "the intellectual sapping operation against the progressive principle." J. Chamberlain, "Book Review" (1953-54) 21 U. Chi. L. Rev. 502 at 502-503.

10. *Supra* note 8 at xxii, xxiii and 94.

11. W.J. Blum, "The Uneasy Case for Progressive Taxation in 1976," Occasional Papers from The Law School, The University of Chicago, no. 11, (Nov. 19, 1976), reprinted in C.D. Campbell, ed., *Income Redistribution* (Washington, D.C.: American Enterprise Institute, 1977) 147.

12. *Ibid.* at 8 and 150.

redistributional purposes.”<sup>13</sup> As Blum accurately observes, “[t]he position that persons are ‘entitled’ to what they own is obviously a view about justice.”<sup>14</sup> “Perhaps the entitlement principle of organization is not the best one imaginable,” he concedes, “[b]ut until a clearly better alternative is developed and gains acceptability, actions that undermine it deserve to be met with much skepticism.”<sup>15</sup> He concluded: “There is no escaping the conclusion that a pattern of steep progression at high levels of taxation does not blend comfortably into a society that heavily relies on traditional notions of private property and private initiative as energizing focuses or tools.”<sup>16</sup>

In 1982, in once again re-assessing the uneasy case for progressive taxation in the light of a decline in economic progress, a high rate of inflation, an increase in welfare payments, and the expansion of the government’s role in society, for reasons that are easy to imagine given the concerns he expressed in his earlier articles, Blum found the case even more uneasy.<sup>17</sup> In part because of the philosophical case prepared by Blum and Kalven, in the early 1980s the idea of flat taxes had become a legitimate issue for public policy in the United States. Since then, it has never been far below the surface of the political agenda.

At present, there is a bewildering array of proposals for fundamental tax reform being considered in the United States, largely sponsored by Republicans and business interests and their allied think-tanks. Somewhat surprisingly, most would replace the progressive income tax not only with a flat rate tax, but with a flat rate consumption tax. Along with what is referred to as the Hall-Rabushka flat tax, the options being considered include a value added tax, a national retail sales tax and a savings-exempt income tax.<sup>18</sup> Replacing the income tax with a consump-

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13. *Ibid.* at 14 and 154.

14. *Ibid.* at 16 and 155.

15. *Ibid.* at 16 and 155-56.

16. *Ibid.* at 16 and 156.

17. W.J. Blum, “Revisiting the Uneasy Case for Progressive Taxation” (1982) 60 *Taxes* 16 at 21, reprinted in M.J. McIntyre, F.E.A. Sander & D. Westfall, eds., *Readings in Federal Taxation*, 2d ed. (Mineola, New York: Foundation Press, 1983) 85 at 90 (“Subsequent developments in our society have made [the case for progressive taxation]. . . no less, and perhaps even more, uneasy.”).

18. For descriptions of the various proposals see H.J. Aaron & W.G. Gale, eds., *Economic Effects of Fundamental Reform* (Washington, D.C.: Brookings Institution, 1996); M.J. Boskin, ed., *Frontiers of Tax Reform* (Stanford: Hoover Institution Press, 1996); M.J. Graetz, *The Decline (and Fall?) of the Income Tax* (New York: Norton, 1997) c. 14; J. Slemrod & J. Bakija, *Taxing Ourselves: A Citizen’s Guide to the Great Debate Over Tax Reform* (Cambridge: MIT Press, 1996) c. 7; A.S. Schenk, “The Plethora of Consumption Tax Proposals: Putting the Value Added Tax, Flat Tax, Retail Sales Tax, and USA Tax into Perspective” (1996) 33 *San Diego L.*

tion tax is being urged largely on the grounds that exempting personal savings from tax will greatly simplify the tax system and produce efficiency gains. Of course the distributional effects of a switch from income to consumption taxes are at least troublesome. A consumption tax exempts income from capital from tax; most income from capital is earned disproportionately by the wealthy.

What is commonly referred to as the flat tax in the United States is generally a reference to a flat rate consumption tax proposed by two economists from the Hoover Institution at Stanford University, Robert Hall and Alvin Rabushka. They originally proposed their flat tax in an article in the *Wall Street Journal* in 1981. Their proposal would have replaced the federal individual and corporate income tax with a two-part, flat rate consumption tax; one part would be levied on the wages of employees and the other part on the cash flow of businesses, minus wages. They published a more detailed version of their proposal in their 1983 book, *Low Tax, Simple Tax, Flat Tax*.<sup>19</sup> The proposal was renamed simply *The Flat Tax* in a slightly revised version published in 1985. Capitalizing on the current interest in flat tax proposals a second edition was published in 1995.<sup>20</sup>

In its economic effect, the Hall-Rabushka flat rate consumption tax is basically equivalent to the Canadian Goods and Services Tax (GST); however, there are two important design differences. First, the tax would not be collected on individual transactions. Instead, businesses would calculate their value added by simply subtracting their purchases of material inputs and investment goods from their total sales. That is, instead of calculating their value added using the credit-invoice method, as they do under the GST, businesses would calculate their value added using what is often referred to as the subtraction method. Second, businesses would be able to deduct from their value added the payments they made to employees as wages. Wages would then be taxed separately in the hands of employees, but at the same rate that applied to businesses. In essence, this flat consumption tax simply takes wages out of the value-added tax (GST) base and taxes them in the hands of employees. The reason that wages are taken out of the business value added calculation

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Rev. 1281; L.B. Snyder & M. Gallegos, "Redefining the Role of the Federal Income Tax: Taking the Tax Law 'Private' Through the Flat Tax and other Consumption Taxes" (1996) 13 Am. J. of Tax P. 1; E. Toder, "Consumption Tax Proposals in the United States" in R. Krever, ed., *Tax Conversations: A Guide to the Key Issues in the Tax Reform Debate: Essays in Honour of John G. Head* (London: Kluwer, 1997) 159.

19. R. E. Hall & A. Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill, 1983).

20. R. E. Hall & A. Rabushka, *The Flat Tax*, 2d ed. (Stanford: Hoover Institution Press, 1995).

is to allow a basic exemption from tax to be provided directly to employees. Thus, unlike the GST, which taxes all value added at a flat rate of 7 percent, the Hall-Rabushka flat tax could exempt wages under a certain amount from tax. Hall and Rubushka argue that this is a much simpler and more efficient method of relieving low-income families of part of the tax burden than other methods, such as the refundable sales tax credit used under the GST.<sup>21</sup> Although the flat tax may appear to resemble an income tax because individuals file and pay taxes, the flat tax is a type of consumption tax because returns on savings and investment are not taxed and business investments are expensed. In their book on the flat tax, Hall and Rabushka propose a 19 percent rate on individuals and businesses, and set the exempt level of income at \$9,500 for a single taxpayer and, for example, for a family of four, at \$25,500 for 1995. They claim that this rate would raise as much revenue as the current U.S. tax system.

The Hall-Rabushka flat tax formed the basis of a number of flat tax proposals introduced in Congress in the early 1980s.<sup>22</sup> In 1992, it surfaced again when Democratic presidential candidate and former California Governor, Jerry Brown, made headlines by advocating a plan to replace the entire federal tax system with a 13 percent flat-rate individual income tax and a 13 percent value added tax.<sup>23</sup> At first his plan garnered considerable media attention, but once it became obvious how regressive it would be both Brown and his proposal slid from view. Many commentators compared it unfavorably to the Hall-Rabushka plan.

Most recently, the flat tax hit the public consciousness in the United States after the Republicans took control of Congress following the 1994 elections. Representative Richard Armey, Majority Leader of the U.S. House of Representatives, and Senator Richard Shelby, introduced a bill in congress in 1995 based upon the Hall-Rabushka plan, the *Freedom and Fairness Restoration Act of 1995*.<sup>24</sup> Their plan would replace the individual and corporate income taxes and the estate and gift taxes with a flat rate tax of 17 percent on individual wages, with a personal

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21. For a discussion of some of the likely long-term differences between a subtraction-method value added tax and the Hall-Rabushka flat tax see K.C. Burke, "VATs and Flat Taxes Reconsidered" (1996) 70 Tax Notes (February 12) 899; and L. Zelenak, "Flat Tax vs. VAT: Progressivity and Family Allowances" (1995) 69 Tax Notes (November 27) 1129.

22. See D.R. Burton, "Major Tax Reform Proposals at a Glance" (1985) 26 Tax Notes (January 7) 75; R.V. Beaudry, "The Flat Rate Tax: Is It a Viable Solution to the Crisis Facing the Internal Revenue Code?" (1984) 9 Okla. City U.L. Rev. 219.

23. For a discussion of the Brown proposal see E. Steuerle, "Flat Taxes and Tax Simplification" (1992) 55 Tax Notes (April 20) 405 and "Flat Taxes" (1992) 55 Tax Notes (April 6) 125.

24. *Freedom and Fairness Restoration Act of 1997*, HR 2040, 105th Cong., 1st sess., March 12, 1997. Details of the tax and the efforts to promote it can be found at the Web site [<http://www.flattax.house.gov>].

exemption of, for example, \$33,800 for a family of four, and a tax on businesses at the same rate. Further support for the plan was garnered in 1996 when a Tax Reform Commission appointed by then Senate Majority Leader Robert Dole and House Speaker Newt Gingrich, and headed by former Representative Jack Kemp, wrote sympathetically about a flat rate consumption tax along the same general lines as the Arme-y-Shelby plan.<sup>25</sup> The Kemp committee, which reported in January 1996, did not expressly endorse a flat tax to avoid embarrassing Bob Dole, who was at the time the front-runner in the Republican presidential candidate race and was concerned about alienating middle-class voters. It merely put forward a set of principles to be followed in replacing the Internal Revenue Code. However, the report did say that a flat tax would simplify the code and lead to an “explosion” of new investment and economic growth.

At the same time, publisher Steve Forbes made a version of the Arme-y-Shelby flat tax the centerpiece, indeed almost the only plank, of his bid for the 1996 Republican presidential nomination. To provide a sense of the enmity that flat taxers display towards progressive taxation, in introducing his flat tax proposal he exclaimed:

No one outside Washington could have devised something more complex, more corrupting, more un-understandable, more anti-growth, more anti-family, a dead weight on life in America, than the tax code today. There is only one thing to do. That is to scrap the system, drive a stake through its heart, kill it, bury it, hope it never rises again to terrorise the American people.<sup>26</sup>

In addition to a somewhat mean-spirited disposition, those who support the flat tax appear to have a zeal for shameless rhetoric. Although his plan at first seemed popular, and momentarily vaulted him from a fringe candidate to an apparently serious contender for the Republican presidential nomination, it soon faded from view and Steve Forbes along with it. He fell from political contention almost as quickly as he rose and withdrew from the nomination race. However, he is still pushing the idea of flat taxes as the honorary chair of the organization, Americans for Hope, Growth, and Opportunity.

Several proposals for flat taxes are at present winding their way through Congress. However, the Arme-y-Shelby plan remains the leading contender. The Congressional House Majority Leader, Richard Arme-y, kicked off his most recent campaign to “Scrap the Code” last fall. At the

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25. National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century* (1996), reprinted in 70 Tax Notes (January 22) 413.

26. Quoted in H. Hertzberg, “Banana Republican” *The New Yorker* (19 February 1996) 50.

press conference he threw sections of the Internal Revenue Code into a trash can and described the income tax as “oppressive, counter-productive, annoying and unfair” and predicted that “[t]he current code will be road kill before you know it.”<sup>27</sup> Although it is not now attracting much public attention, the flat tax remains an important issue on the political and think-tank circuits in the US.<sup>28</sup>

This brief review does not do justice to the immense energy that has gone into proposing and attempting to sell flat taxes in the United States, nor the enormous technical, transitional and other problems such taxes present, particularly when there is an effort not only to flatten the rate but also to shift the base from income to consumption.<sup>29</sup> The review was primarily meant to provide some context for the following discussion of flat taxes in Canada.

### 3. *Canada: Reaching for the Moon, Landing in the United States*

Tax developments in the United States are always significant for Canadians since Canada tends to borrow most of its ideas about tax reform from the United States. Even Canada’s major tax reform effort in 1972,

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27. J. Rieschick, “GOP Lawmakers Step Up Efforts to Turn Tax Code Into ‘Road Kill’” (1997) 76 Tax Notes (September 29) 1661.

28. In the United States, the competing think-tanks are waging a debate over the flat tax on the Internet. Although the sites are numerous, for illustrative offerings, compare those at the left-of-centre Economic Policy Institute, see for example M. Sawicky, “Falling Flat: The Dubious Case for the Flat Tax” Issue Brief #110 (1996) [<http://epn.org/epi/epsawi.html>] and the Progressive Foundation, see for example R.J. Shapiro, “Why Fairness Matters: Progressive Versus Flat Taxes” [<http://www.dlcppi.org/economic.htm>] with the material at the site of the right-of-centre Heritage Foundation, see for example D.J. Mitchell, “A New Tax System: Simple, Fair, and Flat” [<http://taxation.org>]. Jonathan Chait, a columnist for the New Republic, has noted that Daniel Mitchell, the author of this latter tract, is “a fellow from the Heritage Foundation whose sole apparent function is to monitor the print media for insufficiently obsequious references to the sanctity of capital gains and to respond angrily, always taking care to end his letters with a ringing endorsement of the flat tax.” J. Chait, “Washington Diarist: Going Postal” *The New Republic* (3 November 1997). For a comprehensive bibliography on the flat tax debate in the United States over the past two decades, compiled by a strong proponent of flat taxes, see Bruce Bartlett, “Tax Reform: Flat Rate Tax Bibliography” [<http://www.taxation.org/heritage/taxsite/taxlist.html>].

29. See for example J.M. Bickley, “Flat Tax: An Overview of The Hall-Rabushka Proposal” (1996) 72 Tax Notes (July 1) 97; A.L. Feld, “Living With the Flat Tax” (1995) 48 Nat’l Tax J. 603; J.C. Flemming Jr., “Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs, and Consumed Income Effects” (1995) 2 Fla. Tax Rev. 390. I do not deal at all with the many issues relating to a tax mix shift from income to consumption in this paper. I have discussed my reservations about such a tax mix change at length in a monograph about the GST. N. Brooks, *The Canadian Goods and Services Tax: History, Policy, and Politics* (Sydney: Australian Tax Research Foundation, 1992). Later in this paper, in discussing the incentive effects of reducing tax rates, I have borrowed liberally arguments and even paragraphs from this monograph.

that was initiated with the magnificent report of the Royal Commission on Taxation in 1967, and followed 5 years of intense public debate, has been described by Richard Bird and Meyer Bucovetsky as “reaching for the moon and landing, more or less, in the United States.”<sup>30</sup> The business press is fond of warning that Canada must remain tax competitive with the United States. Certainly, many commentators believe that if the United States were to enact a flat tax, Canada would have little choice but to follow suit.<sup>31</sup> Not surprisingly, the political interest in Canada for flat taxes paralleled the two bursts of interest in the United States, first in the early 1980s and then again in the mid-1990s.

As a footnote to Canadian flat tax history, one of the first published proposals for a flat tax in Canada was made by Kenneth Eaton in his posthumously published *Essays in Taxation*.<sup>32</sup> Eaton had spent over twenty-five years in the Department of Finance, retiring in 1958. For most of these years he was Assistant Deputy Minister and chief tax adviser to Ministers of Finance. In his essay chapter on the personal income tax he launches into a sustained and bitter attack on progressive taxation. Although he seems to suggest that he personally favoured a poll tax, or a tax in which everyone paid the same amount, he notes that a flat tax rate of 17 percent could replace the existing progressive rates. He alleges the following benefits would follow the adoption of a flat rate:

It would restore incentives to work harder and better . . . . The middle and upper income groups would have enough left after tax to acquire greater ownership of Canadian industry . . . . Highly trained Canadians could do better for themselves at home than abroad . . . . The incentive to cheat on income tax would largely disappear . . . . Canadians in the income brackets who would benefit from a proportional tax in their improved economic position might give deeper thought to a manner of living. Cultured Canadians might develop among themselves a Canadian culture and encourage the same among the rest of us which would please nearly everybody . . . . Technically, the income tax could be greatly simplified.<sup>33</sup>

He also suggests that the only explanation for progressive taxation is political expediency, under which the majority of low-and middle-income voters support social programs that they benefit from and then

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30. M. Bucovetsky & R.M. Bird, “Tax Reform in Canada: A Progress Report” (1972) 25 *Nat’l Tax J.* 15 at 39.

31. G. Ip, “U.S. tax proposals challenge Canada” *The Financial Post* (16 September 1995) 8; B. McKenna, “Could flat tax spread to Canada? Radical changes to American system would leave ‘no choice’ for northern neighbour” *The Globe and Mail* (17 January 1996) B2; P. Morton, “Canada might be pressured to follow American flat-tax initiative” *The Financial Post* (18 January 1996) 9.

32. A.K. Eaton, *Essays in Taxation* (Toronto: Canadian Tax Foundation, 1966).

33. *Ibid.* at 31-32.

make high-income taxpayers bear their cost. Furthermore progressive taxation is arbitrary in the sense that “it is inconsistent with the concept of private property.”<sup>34</sup> Although he does not make a reference to their monograph, it appears that Eaton was greatly influenced by Blum and Kalven’s *Uneasy Case for Progressive Taxation*.<sup>35</sup>

Following the initial burst of enthusiasm for flat taxes in the United States in the early 1980s, a number of political contenders and politicians attempted to test the waters in Canada. Peter Pocklington, an Alberta business person, made it a central plank in his campaign for the Progressive Conservative leadership in 1983. About the same time, John Evans, a Liberal Member of Parliament, and Chair of the House of Commons Finance Committee, proposed a variant of the flat tax. However, it has been the Fraser Institute, a right-wing think-tank, that has been largely responsible for putting and keeping the idea of a flat tax on the political agenda in Canada. In the early 1980s, the director of the Institute, Michael Walker, published a booklet that stated the case for flat taxes and summarized the various proposals that were then current, including the many legislative proposals in the United States.<sup>36</sup> He concluded:

Our final conclusion on the basis of this preliminary assessment must be that a flat-rate tax system is certainly feasible, that it would produce a certain amount of perverse redistribution of the tax burden but that the extent of this redistribution is likely to be less than is often imagined . . . . It is unambiguously the case that a flat-rate tax would reduce the disincentive to work and productivity imposed by the existing tax system and, on balance, seems to be a direction for reform which deserves the careful consideration of Canadian policymakers.<sup>37</sup>

This interest in the flat tax at the time is reflected in the fact that the Canadian Tax Foundation had a paper delivered at its 1982 annual tax conference on the flat-rate tax. The Foundation invited an American, Joseph Minarik, the Deputy Assistant Director, Tax Analysis Division, Congressional Budget Office, to summarize the proposals being put forward in the United States.<sup>38</sup> He concluded his review by noting that the aspect of the proposed flat taxes that involved broadening the tax base seemed worthwhile, but that “[I]n contrast to broadening the tax base, the flat tax rate comes out looking rather, well, flat.”<sup>39</sup>

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34. *Ibid.* at 27.

35. *Supra* note 8.

36. M.A. Walker, *On Flat-Rate Tax Proposals* (Vancouver: Fraser Institute, 1983).

37. *Ibid.* at 38.

38. J.J. Minarik, “A Flat Rate Income Tax for Canada?” in *Report of the Proceedings of the Thirty-Fourth Tax Conference, 1982 Conference Report* (Toronto: Canadian Tax Foundation, 1993) 37.

39. *Ibid.* at 51.



Throughout the mid and late 1980s, although there was little public attention paid to flat taxes, Canadian academics continued to examine the subject. In a review of public revenues and public policy at a tax conference sponsored by the Fraser Institute, Doug Auld, a public finance economist from the University of Guelph, concluded that a flat rate tax of 21.6 percent of assessed personal income could replace the federal personal, corporate and sales tax. Among other things, he suggested that, “[p]rogressive rates of taxation were largely a feature of wartime taxation. It was deemed improper at that time for individuals to receive very high incomes as a consequence of the war effort.”<sup>40</sup> Another economist, Roger Smith, Dean of the Faculty of Business at the University of Alberta, also endorsed a flat tax. He argued Canada was much better placed than the United States to adopt a flat rate tax since in Canada if the tax base were broadened and the tax rate flattened there would not be nearly as large a shift in the tax burden from higher income classes to middle income classes as there would be in the United States.<sup>41</sup> His general assessment of flat taxes was that, “[b]roadening the base and applying a flat tax rate can increase the perception of fairness, reduce costly distortions created by high marginal rates, have a negligible effect on the overall progressivity of the tax system, and raise the same amount of revenue.”<sup>42</sup>

The flat tax became a political issue again during the public discussion of the implementation of the GST. Dennis Mills, a Liberal MP from Toronto, was the prime mover. He proposed that the federal sales and income taxes be replaced with a flat tax of 25 percent, applicable to both individuals and businesses. His proposed 25 percent rate was revenue neutral only because he assumed, without any evidence, that substantial increased economic activity would follow from a lower tax rate for high income individuals. Moreover, in drafting the technical details of his proposal, which was essentially a flat rate income tax, he and his researchers borrowed many ideas from the Hall-Rabushka flat tax without apparently realizing that it was a flat consumption tax. Consequently, many of the technical details are incoherent. Since he was a Liberal,

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40. D.A.L. Auld, “Public Revenues and Public Policy: The Impact on the Canadian Economy” in J.M. Buchanan, W. Block & M. Walker, eds., *Taxation: An International Perspective* (Vancouver: The Fraser Institute, 1984) c. 4 at 100-101.

41. R.S. Smith, “Flat Rate Tax Potential: A Preliminary Comparison of Three Countries” (1986) 34 Can. T.J. 835.

42. R.S. Smith, “Rates of Personal Income Tax - The Carter Commission Revisited” in W.N. Brooks, ed., *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later* (Toronto: Carswell, 1988) 173 at 183.

perhaps to obscure its origins, and right-wing connections, he called his tax proposal, "The Single Tax," instead of a flat tax. Although originally published in 1990,<sup>43</sup> his proposal has undergone several republications over the years.<sup>44</sup> He continues to trumpet it on every suitable occasion.

Following the resurgent interest in flat taxes in the United States in the early 1990s, a parallel resurgence of interest emerged in Canada. The Fraser Institute held a one-day flat tax conference in Toronto in 1995. However, much of the drive for a flat tax is now coming from the Reform Party. In 1995, the party asked two of its most prominent Members of Parliament, Herbert Grubel and Jim Silye, to prepare a detailed proposal on flat taxes for consideration at the party's biannual assembly of delegates in June 1996. In a paper prepared by these members, along with Ken Boessenkool, an economist from the party's research department, that was first presented at the Fraser Institute conference in October 1995, and then presented to the Reform Party delegates, the authors set out two alternative approaches to a flat tax.<sup>45</sup> The first approach was favoured by Herbert Grubel and called the Pure Flat Tax. It is a consumption tax that essentially eliminates the tax on income from property. The paper asserts that the model has been adapted "to reflect the Canadian fiscal and institutional environment,"<sup>46</sup> however, it is almost impossible to discern anything Canadian about it. It is almost identical to the flat tax proposed by Hall and Rabushka in the United States. In the paper the authors claim that the Canadian tax system must be closely integrated with the American system.

The second approach, favoured by Jim Silye, who found the first approach too radical, was called the Proportional Flat Tax, and was inspired, the paper notes, by the work of Dennis Mills. However, the paper goes on to observe that the Proportional Flat Tax "is more radical than that of Mills because it has fewer deductions from income, allows the same rate of taxation for personal and business income and provides for the elimination of the GST."<sup>47</sup> Also, it notes that the proposed rates for the Proportional Flat tax are revenue neutral, whereas the Mills proposal would create a large deficit.

At the Reform Party's biannual Assembly of delegates in June, 1996, although a party task force had endorsed the Pure Flat Tax, the party did

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43. D. Mills, *The Single Tax* (Toronto: Hemlock Press, 1990).

44. See his Web site at [<http://www.singletax.com/single.html>].

45. K. Boessenkool, H. Grubel & J. Silye, "A Flat Tax for Canada" (The Flat Tax Conference, Fraser Institute, 31 October 1995) [unpublished; available at <http://www.reform.ca>].

46. *Ibid.* at 1-2.

47. *Ibid.* at 10.

not commit itself to either version of the flat tax.<sup>48</sup> Apparently, the party executive had some reservations about endorsing the Hall-Rabushka model and Jim Silye, an influential party member, continued to press for his less radical version. In retrospect, Herbert Grubel has noted that the failure to commit to either plan was a useful political ploy since the confusion prevented the government from discrediting “our own analysis of incidence, costs, and benefits of specific proposals.”<sup>49</sup> In more recent discussion papers the Reform Party has not committed itself to a flat tax but only tax cuts and reduced high marginal tax rates.<sup>50</sup>

Just to round out this story about the fate, so far, of the flat tax in Canada, in late 1995 and early 1996, particularly after Malcolm Forbes appeared to have some success with the idea of a flat tax in the United States, the Canadian media was full of stories about the flat tax. Canada’s weekly news magazine, *Maclean’s*, ran a lead story about flat taxes.<sup>51</sup> The editorial board,<sup>52</sup> and most of the columnists at *The Financial Post*, have written stories supporting flat taxes.<sup>53</sup> *The Globe and Mail* columnists

48. Herbert Grubel recounts the development of these proposals and the subsequent politics in a panel discussion, G.P. O’Driscoll, Jr., *et al.*, “Tax Reform” (1997) 15 *Contemp. Econ. Pol’y* 1 at 3-6.

49. *Ibid.* at 5.

50. See “Beyond A Balanced Budget: A Discussion of the Options for Debt Retirement, Tax Relief and Responsible Future Spending” prepared by the Office of the Official Opposition of Canada, September 11, 1997 [<http://www.reform.ca/babb/index.html>].

51. M. Janigan, “Flat-Tax Flak” *Maclean’s* (19 February 1996) 34.

52. Editorial, “Flattax deserves a close look” *The Financial Post* (20 January 1996) 16.

53. D. Francis, “Flat taxes the way to end vicious evasion circle” *The Financial Post* (21 August 1993) S3; J. Geddes, “Floating the flat-tax balloon over a tax-weary Canada” *The Financial Post* (1 July 1995) 1; N. Nankivell, “Flat-rate federal income tax would be better than existing system” *The Financial Post* (15 June 1995) 15. Somewhat interestingly, one of *The Financial Post’s* former contributing editors, who regularly wrote on tax issues, expressed repeated scepticism about the wisdom and politics of a flat tax. See Samuel Slutsky, “Flat tax means rich get richer and poor get taxed” *The Financial Post* (15 August 1995) 25 and “Flat tax blocked by reality” *The Financial Post* (25 June 1996) 28. However, every time he wrote a column critical of flat taxes he was blasted by letters to the editor. In part to further show the complexities and deep-rooted ideologies at stake in the flat tax debate, after one column, in which he suggested that the flat tax was attractive but unworkable because it would mean that tax incentives, such as the tax credits for charities, that were both worthwhile and supported by politically powerful groups, would have to be removed, he was severely taken to task in a letter to the editor from Reuven Brenner, the Director of the McGill Economics Centre. Brenner first questioned, “[w]hat can [Slutsky] be talking about” when he asserts that charities are the “largest single organized group doing good in any societies” and therefore deserve a tax break? Brenner pointed out that, “[t]he facts that I am acquainted with are that cheaper shoes and vaccines manufactured by profit-motivated companies have saved far more lives than the much publicized actions of all the Mother Teresas combined. How much good charities do, is certainly a matter open for debate.” However, he did agree that it was unlikely that a flat tax would ever be enacted, but not for the reasons that Slutsky gave. He asserted: “The main reason is not that accountants, lawyers and many other groups have the incentive to lobby against it, but that politicians know that such a tax destroys their power. In the absence of military threats,

have written in support of the tax but, interestingly, the editorial board of *The Globe and Mail* is at least equivocal about the idea of flat taxes.<sup>54</sup> In April, 1995, they suggested that the flat tax proposals being considered in the United States ought to be one of the policy ideas the federal Progressive Conservative party consider in order to rejuvenate itself.<sup>55</sup> However, almost a year later, in an editorial titled, "Flat tax, flat earth," they expressed reservations about a flat tax, although their main concern appeared to be not with the idea of the flat tax itself but proposals that at the same time offered a tax cut with the promise that it would spur sufficient economic activity to pay for the tax cut.<sup>56</sup> The editorial referred to the Republican's "infatuation" with the flat tax to be "no less foolish than the one they have long had with supply-side economics."<sup>57</sup> It went on to note that "the belief the GDP growth rate can be quickly doubled through tax cuts, as a Republican Party commission headed by Jack Kemp asserted last month, is one more trip into the land of voodoo economics."<sup>58</sup> Some columnists, particularly those at *The Toronto Star*, have been critical of the flat tax; for example, Dalton Camp asserted that, "[i]t doesn't fit the needs of our economy and it doesn't suit our society — not because it's someone else's idea, but because it's not our idea of what tax reform needs to be about. Having to choose between a tax system that encourages anarchy, and another that encourages an oligarchy, is no choice at all."<sup>59</sup>

The most recent proposal for a flat-rate direct consumption tax in Canada has been made by Jonathan Kesselman, an economist at the University of British Columbia. He has suggested that the GST be replaced with such a tax.<sup>60</sup> His proposal is very similar to the Hall-Rabushka proposal to replace the income tax with a flat-rate direct-consumption tax, however, since he is suggesting only replacing the GST

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the power of politicians comes from little more than selling and closing tax loopholes. They will never pull the carpet out from under their own feet." R. Brenner, Letter to the Editor, *The Financial Post* (8 September 1995) 12.

54. See A. Coyne, "Flat tax can also be fair tax" *The Globe and Mail* (22 February 1996) B16; and P. Cook, "Flatter taxes, or flattened politicians" *The Globe and Mail* (12 February 1996) B7.

55. Editorial, "Ideas for a Conservative revival (1)" *The Globe and Mail* (24 April 1995) A14.

56. Editorial, "Flat tax, flat earth (I)" *The Globe and Mail* (2 February 1996) A12; "Flattax, flat earth (II)" *The Globe and Mail* (3 February 1996) D6.

57. "Flattax, flat earth (I)," *ibid.* at A12.

58. *Ibid.*

59. D. Camp, "Flattax doesn't belong in true north, strong and frozen" *The Toronto Star* (17 January 1996) A17.

60. J.R. Kesselman, *General Payroll Taxes: Economics, Politics, and Design* (Toronto: Canadian Tax Foundation, 1997) c. 8.

with such a tax, and not the income tax, it could be levied at a much lower rate, as low as 3 percent, and thus avoid many of the transitional and distributional consequences of the Hall-Rabushka proposal.

This is not the place to assess the Hall-Rabushka type flat rate consumption tax as an option for Canada, except to note that aside from the inequity and dubious economic benefits of consumption taxes, the tax itself, in any of its many guises, is replete with complexities and transitional problems and would be unlikely to lead to much simplification for the average taxpayer. It would, of course, simplify paying taxes for wealthy individuals by simply exempting dividends, interest income and capital gains from tax. It is no trick to simplifying any law by abolishing it. Also, I doubt that when average Canadians suggest the tax system should be simplified they mean taxes should simply be repealed on forms of income received primarily by high-income Canadians, or that when Canadians suggest the many loopholes for capital income should be dealt with they mean those loopholes should be converted into one all-encompassing loophole.

### III. *Clarifying the Issues*

The proponents of flat taxes make a number of beguiling claims. First, they argue that a flat tax rate will greatly simplify the income tax by making it easier to understand, more convenient to comply with, and less expensive to administer. They also argue a flat tax rate will substantially reduce tax avoidance and evasion. Second, in addition to administrative advantages, a flat tax rate will have significant economic benefits. It will increase the living standards of all Canadians by encouraging taxpayers, particularly rich and able Canadians, to work harder, save more, and undertake more entrepreneurial activities and risky investments. It will also encourage talented Canadians to remain in Canada and not migrate to more tax-hospitable climates. Third, flat taxers contend that a flat tax will have significant political advantages. It will increase the transparency of the tax system by reducing the futility and hypocrisy of high rates, make abolishing tax loopholes politically easier by reducing their value to high-income taxpayers, and constrain high government expenditures by ensuring that all voters share the costs of such expenditures in the same proportion. Finally, proponents make a fairness argument for flat taxes; namely, that only a tax system in which everyone pays the same proportion of their income in tax can make a claim of treating everyone equally.

All of these arguments are dead wrong - their logic is faulty, their factual premises are not supported by the weight of empirical evidence,

and their normative judgments are perverse. The only significant effect of a flat tax rate will be to shift even more wealth and power to the already wealthy and powerful. Moreover, a flat tax is contrary to the basic principles of an equitable tax system and the social goals of Canadians. A cardinal principle of tax fairness in Canada has always been that those with greater ability to pay should pay a larger percentage of their income in tax than those with less ability to pay. A widely accepted social goal of Canadians is that governments should use the tax/transfer system to achieve a more socially acceptable distribution of income than that which results from unrestrained market forces. As John Geddes has claimed, “[t]he concept of a flat tax, like the notion of a flat earth, is a triumph of simple-mindedness over reality.”<sup>61</sup>

Before refuting the claims made by the flat taxers, three preliminary points need to be made to clarify the issues since flat taxers have deliberately misconceptualized the terms of the debate over tax rates. First, the precise definition of a flat tax needs to be clarified since the tax design that flat taxers are generally proposing is not clearly indicated by the phrase “a flat tax.” Second, the concept of flat taxes needs to be distinguished from other concepts that flat taxers frequently attempt to conflate along with a flat tax rate in order to make flat taxes appear intuitively appealing. Finally, flat taxers normally address their arguments only to the income tax and ignore the other tax bases in the tax system and other government policy instruments that have important redistributive consequences. As a result, to some degree, the whole idea of flat taxes is conceptually incoherent, at least when its adoption is being urged on grounds of fairness. As commonly used by its advocates, the term ‘flat tax’ is highly misleading. Flat taxers are not normally advocating a flat tax in the sense that everyone’s tax liability should be the same; that is, that the tax itself should be flat. Economists refer to a tax in which everyone pays the same amount as a lump-sum tax. When levied, it is usually assessed as a poll tax. Experience with poll taxes, most recently in the guise of the British “community charge,” reveals them to be difficult to administer and, most tellingly, in violation of almost every citizen’s sense of fairness. The attempt to levy a poll tax was largely responsible for the fall of a Prime Minister of the United Kingdom, Margaret Thatcher.<sup>62</sup> It is the rate of tax, rather than tax liability, that does

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61. J. Geddes, “Flat-tax debate is not about simplification after all” *The Financial Post* (27 January 1996) 20.

62. See J. Gibson, *The Politics and Economics of the Poll Tax: Mrs. Thatcher’s Downfall* (Warley, U.K.: Emas, 1990) and D. Butler, A. Adonis & T. Travers, *Failure in British Government: The Politics of the Poll Tax* (Oxford: Oxford University Press, 1994).

not change as income increases under most proposed flat taxes. Under most proposals, a single rate of tax would replace the graduated tax rates in the present income tax system.

However, even to call most proposed flat taxes single-rate taxes is misleading. Flat tax proposals invariably exempt a certain amount of income from taxation. For that reason, they are, in fact, a form of graduated tax, with an initial bracket to which a zero tax rate applies, and then an open-ended bracket above this amount subject to a single rate of tax. A single-rate tax with an exemption is more accurately referred to as a dual-rate tax system than a single-rate system.

The proponents of flat taxes presumably do not refer to their proposals as dual-rate taxes because then it would be clear that conceptually their proposals are not so different from the present progressive tax system. On its face, not too much could turn on whether a tax system has two or four rates, as does the present Canadian tax system. Indeed collapsing the rates from four to two would not affect most people. Under the present progressive rate structure, almost 70 percent of tax filers are in the bottom two brackets. They have taxable incomes of under \$30,000.<sup>63</sup> Essentially, the system is already flat for them. Thus whatever the advantages of the so-called flat-rate system, it will only accrue to the top 30 percent of income earners who are now in the top two brackets. Put this way, that is by referring to the proposed system as a two-rate system, which would replace the present four-rate system, makes it more obvious what the exercise is all about, namely, reducing the taxes paid by high-income individuals. Proponents likely call their proposal a flat tax so that it sounds like a radical new idea that must mean more than simply reducing tax rates for a relatively small percentage of the population who happen to have high incomes.

Contrary to the suggestion implicit in a reference to a flat tax, a dual-rate income tax is progressive. Assume that a flat-tax proposal exempts the first \$10,000 of an individual's income from tax and then levies a 20 percent rate on the excess. Individuals earning \$20,000 would pay 20 percent of their income in excess of \$10,000 in tax, or \$2,000, which would be an effective rate of tax on their earnings of 10 percent. At \$50,000 they would pay \$8,000 in tax, for an effective rate of 16 percent. At \$100,000, the effective rate of tax would be 18 percent. Thus because of the exemption, the tax would be progressive, particularly over lower-income ranges. As the exemption becomes a smaller percentage of the income of individuals the rate becomes essentially proportional. The

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63. Revenue Canada, *Tax Statistics on Individuals: 1995 Tax Year* (Ottawa: Revenue Canada, 1997), Basic Table 2.

point is that a flat tax is progressive, just not very progressive, particularly over high-income ranges. Again, presumably the reason that flat taxers do not advertise the progressive nature of flat taxes is because then it becomes obvious that what the debate is about is what rates of tax should apply to high-income individuals. That is likely to be a less interesting proposition for most middle-class individuals than the promise of a radical new tax system.

But if the real agenda of flat taxers is simply to reduce taxes for the rich, and a necessary result of their gambit is the middle-class will get soaked, how do flat taxers convince the average individual that flat taxes are a good idea? They have attempted to do so by conflating a number of unrelated issues, namely, rate reductions for high-income individuals with a broadened tax base, overall tax reductions and simplicity.

The most effective, but misleading, strategy of flat taxers has been to link reducing the tax rates with broadening the tax base. That is, they contend that what flat taxes are all about is getting rid of tax loopholes, particularly those that benefit the rich, and then flattening the rates. Yet expanding the tax base has no necessary connection with reducing tax rates. The scope of the tax base and the shape of the tax rate structure are conceptually distinct issues. The tax base could be expanded and the rates left as they are or even made more progressive. The reasons why flat taxers attempt to conflate these issues is obvious. Many of the advantages they claim for their flat rate proposals, such as simplicity, follow not from flattening the rate structure but from broadening the tax base.

Second, flat taxers attempt to link reduced tax rates with tax cuts. If tax rates are to be reduced for high-income individuals, and low-income individuals are to be exempt from tax by a large basic exemption, how is it possible that middle-income individuals will not get soaked? The only possible answer is if the flat-rate tax system raises less revenue than the current one. Most flat taxers frankly acknowledge that a flat tax could not be sold unless the bottom line is tax relief. Well, if the presumed outcome is lower taxes for everyone, and no connection is made between reduced taxes and reduced public services, a tax reform based upon anything from the weight of taxpayers to average local rainfall could likely be sold by any political party - no trick there. A more revealing test of any proposed change is how it compares with the present system when the assumption is made that it must bring in the same amount of revenue. Tax cuts have nothing whatever to do with the merits, if any, of a flat tax. If reduced taxes for everyone were the objective, it could easily be achieved without at the same time providing a big tax break for the rich by flattening the tax rates. The fairest way to reduce income taxes is to simply increase the basic exemption.



The purpose of muddling these issues - base broadening, the overall level of taxes and flat rates - is obvious. It is a way to get middle-class political support for what amounts to a huge tax reduction for the rich. Many people are in favour of removing loopholes, particularly those they do not benefit from, and some people are in favour of a tax cut. But the great majority of Canadians, as public opinion poll after poll has shown, think the rich should pay more not less tax. Therefore, the only way the proponents of flat taxes think they can sell their tax reform is by suggesting these issues are inextricably linked.

Finally, by way of clarifying the issues in the flat tax debate, it is important to note that for a number of reasons there is an important sense in which the whole ideal of flattening the income tax rates is conceptually incoherent, at least if it is being urged on grounds of fairness. First, even if members of a political party thought that everyone should pay the same percentage of their income in tax, on the basis of some misguided fairness argument, they could not be in favour of a flat-rate income tax. The reason for this is that high-income individuals tend to receive all sorts of income that will never be taxed under any broadened income tax base politically imaginable. For example, the present income tax does not include in its base, and no flat rate tax proposal I have seen has proposed including, such items of income as gifts and bequests (which are received almost exclusively by high-income individuals), accrued capital gains (which are earned almost exclusively by high-income individuals), or the imputed rental value of homes (a form of income received disproportionately by higher-income individuals). In fact, if a broad measure of income that includes these amounts is used, even Canada's existing progressive income tax rate structure does not lead to much progressivity at high-income levels, and for incomes over \$300,000 the present system is actually regressive. Families with broad income of \$150,000 to \$300,000 pay on average about 16 percent of their income in income tax, while those with income over \$300,000 only pay 14.5 percent.<sup>64</sup>

Second, even if the income tax base could be broadened so that it was completely comprehensive, and for reasons of fairness a political party thought that everyone should pay the same percentage of their income in tax, they could still not be in favour of a flat-rate income tax. The reason for this is that the income tax is only one of many taxes in the overall tax system and it is the only progressive tax. All other taxes, such as sales taxes, property taxes, and excise taxes, under the most reasonable

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64. F. Vermaeten, W.I. Gillespie & A. Vermaeten, "Tax Incidence in Canada" (1994) *Can. T.J.* 348 at 375.

incidence assumptions, are regressive, that is, low-income individuals pay a larger percentage of their income in these taxes than high-income individuals. It is difficult to think of a reason for being concerned, on grounds of fairness, that everyone pay the same proportionate amount of their income in income tax, but being indifferent to the fact low-income individuals pay a much larger percentage of their income in these other regressive taxes than high-income individuals. If it is fair that everyone pay the same percentage of their income in taxes, the income tax has to be progressive simply to offset the regressivity of the other taxes in the tax system. Flat taxers should, in fact, be content with the present system since under the present tax system practically every family, no matter what their income, pays about 35 percent of their income, broadly defined, in tax. Low-income families pay about 30 percent of their income broadly defined in tax. The percentage of their income paid in tax increases slightly for families until their income reaches about \$50,000 at which point they pay about 34 percent of their income in tax. However, beyond this middle-income range taxes paid as a percentage of income remains about the same.<sup>65</sup>

Finally, there is an even more fundamental reason why arguments for flat taxes based on some notion of fairness are utterly conceptually incoherent. This is the reason. Any argument that suggests that the redistributive consequences of tax laws should be constrained for reasons of fairness, by flattening the rates, necessarily rests upon the assumption that conceptually the distributive consequences of tax laws are somehow different than the distributive consequences of other government regulatory regimes including the rules of property and contract laws. But, of course, this is nonsense. Every form of government regulation has distributive consequences. Providing professionals such as doctors and lawyers with a monopoly necessarily results in significant beneficial redistributive consequences in their favour; regulations providing inventors with the exclusive right to exploit their patented inventions for a number of years has made billionaires out of some; and health, safety and consumer regulations often disproportionately affect the income of lower-income families.

In addition to more overt forms of government regulations, the background rules of property and contract law that govern market place transactions also have important, but unintended, distributional consequences. What economists often refer to as a self-regulating, neutral and free market place is, in fact, comprised of legal rights and commercial

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65. *Ibid.* at 372.

exchanges that are created and regulated by a seamless web of rules, standards, distinctions and judgements that collectively constitute the rules of property, contract and tort law. None of these rules were ordained by God. None sprang from nature. Even in the nineteenth century, when most of these rules were formulated, they simply represented the value judgments and policy decisions of common law judges. In part, judges formulated these rules by considering the same issues of loss distribution and social welfare that are considered by legislators in enacting modern regulatory regimes such as tax laws. In establishing the incidents of property ownership, these rules significantly affect the value of property rights; in establishing the ground rules for trade and exchanges, they significantly affect the relative bargaining strength of the parties. Thus they have decisive and pervasive distributional consequences. If an individual violates one of these so-called free market rules, another private party can bring the full coercive power of the state to bear upon that person by initiating a court action. In all of these respects these rules are identical to tax laws. Indeed, the very expression “laissez-faire,” which is often used by those favouring flat taxes in other contexts, is simply a clever marketing ploy; it is a gross misdescription of any market. There is simply no possibility of a “neutral,” “unregulated” or “free” market. Note that what I am claiming here is not that historically free markets have not existed because the government has always insisted on regulating them, but that the whole notion of an unregulated market is incoherent; just like tax laws, the rules governing markets are created by the state, they favour some over others, and they are necessarily coercive. Thus it reflects a fundamental conceptual confusion to suggest that for some reason the distributive effects of tax laws should be constrained on grounds of fairness, but not at the same time insist on flattening the distributive effects of rules of property and contract law—whatever that might mean.

At the end of the day, presumably what members of a society care about is whether the distribution of economic resources in that society is morally acceptable after the intervention of all government regulatory regimes, including the regulatory regime commonly referred to as the rules of the private marketplace. Therefore, why should they attempt to disable or constrain the distributive consequences of only one government instrument, or propose a theory of fairness that would apply to one regulatory regime, but not to the others?

Having suggested that the notion of a flat tax is misdescribed, has an intuitive appeal only because its proponents attempt to piggy-back it on the unrelated ideas of base broadening and tax cuts, and that it is

conceptually incoherent, let me now turn directly to some of the arguments that its proponents advance.

#### IV. *Refuting the Claims of Flat Taxers*

##### 1. *A Simpler Tax System*

Perhaps the most appealing feature of a flat tax is the claim that it will simplify the tax system. The idea that the income tax system could be made easy to understand, convenient to comply with, and straightforward to apply, has an obvious attraction. So much so that everyone with a tax design tries to trade on the virtues of simplicity. It is the one issue upon which even tax lawyers can speak publicly and sound like statespersons while attempting to achieve special tax breaks for their clients. The need for simplicity is thus often used as a slogan to obscure a hidden agenda. In Canada, during the last major tax reform exercise in 1987, when the rates were reduced from 10 to 3 brackets, one of the government's most brazen red herrings during the debate was the claim that this would simplify the tax system.<sup>66</sup>

In the context of tax law, the concept of complexity is generally taken to refer compendiously to three different aspects of the tax system: technical complexity refers to the difficulty of simply understanding the legislation; structural complexity refers to the difficulty of interpreting and applying the law with certainty; and, compliance complexity refers to the variety of record-keeping, form-completing and other tasks that a taxpayer must perform in order to comply with the law.<sup>67</sup> The modern Canadian income tax system is complex in all three respects.

When first enacted in 1917, the income tax was legislated in under 11 pages; today the consolidated legislation requires more than 1,400 very

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66. See N. Brooks, "The Changing Structure of the Canadian Tax System: Accommodating the Rich" (1993) 31 *Osgoode Hall L.J.* 137.

67. The literature analyzing problems relating to the simplification of the tax law is legion. For recent representative articles see R. D. Brown, "Tax Simplification: Simple or Simplistic?" in *Report of the Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996) c. 5; G. S. Cooper, "'A Rose Is a Flower Is a Plant': Tax Simplification South of the Equator" *Report of the Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996) c. 3; M. Gammie, "Tax Simplification: Right Path or Dead End?" *Report of the Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996) c. 2; E. J. McCaffery, "The Holy Grail of Tax Simplification" (1990) *Wis. L. Rev.* 1267; and D. Schenk, "Simplification for Individual Taxpayers: Problems and Proposals" (1989) 45 *Tax L. Rev.* 121.

finely printed pages. The drafting is undeniably Byzantine. In some sections, single sentences roll on for almost a dozen pages as refinements are grafted on to the exceptions to the provisos. The terms used are unfamiliar: balance of annuitized voluntary contributions, butterfly transactions, capitalization of soft costs, cumulative offset account, and countless other concepts used in the *Act* are not part of everyday language. A famous American judge once remarked that the words of the income tax “merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—[and] leave in my mind only a confused sense of something vitally important but successfully concealed . . . .”<sup>68</sup> Since the legislation is so fundamental to each citizen’s responsibilities to the state, the idea that everyone should be able to read and understand the *Act* seems uncontentious.

The fact that tax law is difficult to apply to some circumstances and transactions is indisputable. Every spring, Toronto newspapers, and I am sure newspapers in every other city, invent an income tax situation of moderate, but not exceptional, complexity and invite some number of professional tax preparers to calculate the appropriate tax liability. The newspapers generally receive back a different answer from each professional that returns the form.<sup>69</sup> Another springtime ritual at many newspapers is calling Revenue Canada’s toll-free numbers and asking the same set of questions to several taxpayer service representatives. Again, some large percentage of questions are invariably answered inconsistently and incorrectly. As a further indication of the difficulty of applying the tax rules, every year 50,000 to 55,000 taxpayers file notices of objection to Revenue Canada’s assessment of their tax returns. Following the administrative appeal procedure, about 4,000 tax disputes are annually appealed to the Tax Court.<sup>70</sup>

Complying with the tax laws is a costly affair for many taxpayers. In 1995, over 40 percent of Canadian taxfilers paid a professional tax

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68. L. Hand, “Thomas Walter Swan” (1947-48) 57 Yale L.J. 167 at 169.

69. See for example D. Flavelle, “Tax preparers give 3 different answers” *Toronto Star* (28 March 1998) B1 (three different tax preparers calculated three different refunds due on the same typical return submitted to them ranging from \$650 to \$2,160. The tax preparer’s fees varied about as much as the tax refund they calculated, from a low of \$56 to a high of \$250).

70. Canada, Auditor General of Canada, *Report of the Auditor General of Canada to the House of Commons*, vol. 1, April, 1998 (Ottawa: Minister of Public Works and Government Services Canada, 1998) at 5-12.

preparer to assist them in filing their tax return.<sup>71</sup> Professor Francois Vaillancourt has estimated that on average individual taxpayers preparing their own return devoted 5.5 hours to the task in 1985.<sup>72</sup> He also estimated that the total cost to the government and individual Canadian taxpayers for administering and complying with the personal income tax and various payroll taxes was about \$5.5 billion in 1986.<sup>73</sup> The promise, often made by flat taxers, that if tax rates were flat everyone could fill out their tax returns on the back of a post card, presumably during a commercial break while viewing *The National/CBC News*, has an obvious attraction.

In spite of the apparent urgency of simplifying the tax system, the proposition that flattening the tax rates will do so is patent nonsense. None of the difficulties of understanding the *Act*, the mistakes that professionals make in filing returns, the wrong answers that Revenue Canada agents give in answering taxpayer's questions over the telephone, or the headaches involved in filling out a tax return, has to do with applying the tax rates. The section in the *Act* that sets out the tax rates is one of the most straightforward: it is scarcely a dozen lines.<sup>74</sup> It has not been the subject of any court cases or interpretive problems, so far as I am aware. No one has trouble applying this section. Further, once someone's taxable income is calculated on their tax return, a grade three student can calculate the tax owing, no matter how many rates there are. Whether the tax structure has 2 or 87 rates, once taxable income is determined the calculation of tax owing requires only 2 lines on the return.

The fact that the rate structure has nothing to do with the complexity of a particular tax is obvious when one considers that the tax system is full of taxes with flat rates and yet none are simple. Most notably, the corporate income tax is basically a flat rate tax system, all corporations apply the same basic corporate tax rate to their taxable income, and yet in contrast to it the individual income tax is simplicity itself. While most law students handily survive the rigours of the individual income tax course, the majority are traumatized by the complexity of corporate

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71. Information obtained from Revenue Canada, Communications. Of the 40 percent of tax filers who paid someone to fill out the forms, 15 percent (of all tax filers) paid an accountant or lawyer while about 13.5 percent paid a specialized tax service preparer, such as H&R Block. Another 10 percent of taxpayers had a friend or relative prepare their tax return for free. D. Flavelle, "Beware when hiring preparer" *Toronto Star* (28 March 1998) B5.

72. F. Vaillancourt, *The Administrative and Compliance Costs of the Personal Income Tax and Payroll Tax System in Canada, 1986*, Canadian Tax Paper No. 86 (Toronto: Canadian Tax Foundation, 1989) 45.

73. *Ibid.* at 83.

74. *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s. 117(2).

income tax courses. The alternative minimum tax for individuals is a flat 17 percent, yet to calculate it requires the same complexity as the income tax itself. The federal goods and services tax (GST) is levied at a low flat rate of 7 percent. Yet the GST is an expensive tax to administer and imposes large compliance costs on the private sector, particularly small businesses, estimates range from \$1.5 to \$4.6 billion.<sup>75</sup> Even though the GST was only enacted in 1991, there are now as many tax guides and looseleaf services and other advisory services attempting to make sense of it as there are for the income tax.

One way of illustrating that the rate structure has almost nothing to do with the complexity of the income tax system is to briefly examine the elements of the system. The income tax is composed of two distinct elements: a technical tax system designed for raising revenue and a tax expenditure system designed for providing government subsidies. The first element consists, in turn, of six structural components necessary to implement a revenue-raising tax on income, each has inherently complex characteristics.

*Jurisdictional rules.* All income tax systems, regardless of their rate structure, require a complex set of rules defining what individuals, corporations, trusts, and other units will be subject to the tax on a personal basis. They also need an equally complex set of rules defining what income will be subject to tax within the jurisdiction because the income's economic nexus with the jurisdiction is sufficiently close that the jurisdiction can justifiably tax it regardless of the personal residence of the owner. Measures providing for double taxation relief, the allocation of income and expenses to activities within the jurisdiction, and the prevention of international tax avoidance, constitute some of the most intricate and detailed rules in any income tax system that takes seriously the preservation of its tax base and the competitiveness of its industries in an open and integrated world economy. All of these rules, and many others that are needed to deal with cross-border and international transactions, are required regardless of the flatness of the rate structure.

*Base of the tax.* Whatever the tax rate structure, the base to which it is to apply has to be clearly specified. On the assumption that the base is to be 'net income,' precisely defining the base is no easy task. Defining 'gross income,' in order to arrive at net income, presents almost intractable problems. Given the structural design of the Canadian income tax base, for example, a number of potential sources of gross income have to

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75. J.R. Kesselman, *General Payroll Taxes: Economics, Politics, and Design*, Canadian Tax Paper No. 101 (Toronto: Canadian Tax Foundation, 1997) 313.

be distinguished such as income from employment, income from property, income from business and capital gains. Not only must each of these items of gross income be distinguished from one another, but also each must be distinguished from sources of income that are not taxed such as nontaxable conditions of employment, windfalls, gifts, gambling winnings, and earnings from a hobby. Furthermore, gross income must be distinguished from a recovery of capital and other transactions that do not necessarily result in an increase in the taxpayer's net wealth. Once having determined a taxpayer's gross income, to arrive at his or her net income further difficult conceptual issues must be resolved such as the distinction between personal and business expenses and current and capital expenses. The dozens of disputable margins between these various concepts alone account for a good deal of tax complexity; their explication comprises the great bulk of most basic law school courses in tax law; and, the great majority of reported tax cases involve sorting them out and applying them to the infinite variety of personal and commercial transactions. Since they have to do with defining the appropriate tax base to which to apply the rate of tax, problems associated with distinguishing between these concepts would arise as frequently under a flat tax as under a progressive rate tax.

*Period of measurement.* Income is computed under most tax systems, and the rates applied, on an annual basis. This means that a series of rules are needed to allocate items of income and expenditures to particular periods. Moreover, rules are needed, such as loss carryover rules, to alleviate the unfairness involved in somewhat arbitrarily requiring individuals to compute their income on an annual basis. In order to make the administration of the tax feasible, tax drafters frequently look to financial accounting and traditional accounting principles for standards to apply in dealing with period of measurement problems. Nevertheless, the resulting rules are often intricate. This is particularly the case since some kinds of gains, such as capital gains, are only taxed on a realization basis. Indeed, this feature of the tax system, namely that capital gains are not taxed as they accrue but only when realized, undoubtedly accounts alone for more tax complexity than the slope of the rate structure. Since flat taxes do not eliminate the advantages of tax deferral all these rules would be necessary in a flat rate tax system.

*Units to be taxed and attribution rules.* A fourth essential component of every income tax are rules to define the units to be taxed and rules to ensure that income is attributed to the appropriate taxpaying unit. In Canada, the individual is the basic unit of tax and the *Act* contains a series of rules to ensure that income is attributed to the individual who earns income or who otherwise controls its source. Although the tax unit must



be defined whether the rate is flat or progressive, those who push for flatter taxes sometimes argue that one possible simplification when the rates are flatter is that detailed attribution rules would not be necessary: if everyone's tax rate is the same there is no incentive for income splitting, that is, for attempting to assign one's income to someone else, such as a spouse or child, who lives in economic mutuality with the taxpayer but whose tax rate is lower. One hears a good deal of nonsense about this point. As mentioned above, for almost 70 percent of the taxpayers under the present tax system the rates are essentially flat. Moreover, almost 90 percent of taxpayers earn their income from employment and have no opportunity to assign it to some other individual. The only sources of income that are subject to manipulation by taxpayers anxious to split their income for tax purposes with their lower-income spouses and children are taxpayers who earn business income and income from property. Generally these tend to be higher-income taxpayers. The general rules and principles as to who must pay tax on income are intuitively understandable and straightforward. The complex attribution or income-splitting rules are essentially default rules: they only come into effect when high-income individuals with business or property income are attempting to avoid the rules. Does it really matter if the *Act* must contain complex rules to prevent these individuals from avoiding tax? Moreover, all of the rules that are at present in the *Act* in order to prevent income splitting would have to remain even if the rate were flattened. The reason for this is that under all flat tax proposals a large exemption (effectively a zero rate bracket) is provided for low-income individuals. Thus there would still be substantial opportunities to save tax by income splitting among family members. Indeed, since under some flat tax proposals the basic amount exempt from tax is even larger than it is under the present system, for some families the incentive for income splitting might be even greater under a flat tax than under the present system.

*Rates of tax.* The provision of the *Act* dealing with the rates of tax now requires about 12 lines. Admittedly, this might be reduced to 8 lines if the rate structure were reduced to one rate instead of three.

*Administrative rules.* The *Act* contains a detailed set of rules dealing with such administrative matters as who must file a tax return, what information must be provided to the tax department, assessments, reassessments, the payment of tax, withholding taxes, instalment payments, the need to keep books and records, civil penalties, investigative powers and powers of search and seizure, notices of objection, tax evasion, and so on. All the rules necessary to collect and administer the tax are required regardless of the rate structure. It is sometimes argued that indirectly a flatter income tax, and in the extreme a flat tax, may reduce administra-

tion and compliance costs by enabling greater use of administratively efficient withholding taxes. For example, if almost everyone faces the same rate, say 20 percent, then most tax could be remitted at the source of the income payment, rather than by the recipient. Employers could withhold 20 percent of everyone's wages, banks could withhold 20 percent of interest payments, and corporations could withhold 20 percent of dividends. With comprehensive and accurate withholding most individuals would not have to file a return at all since no tax would be owing or refund due. However, again, this advantage of flat taxes is vastly overstated. Withholding now works reasonably well for employees who can estimate their income for the year and could easily be expanded to other sources of income under the present system. If it was expanded there might be some over- or under-withholding for particular individuals, but this would also be the case under a flat rate system. Under the flat rate system some recipients of interest and dividend income, for example, would be low-income elderly individuals or others who would fall into the zero-rate bracket or be individuals who had incurred considerable expenses earning their income from property. Moreover, the point of requiring taxpayers to file a return is not just to require them to inform the tax department of their estimated tax liability but to collect sufficient information from them so the department can determine whether the return should be audited.

The point of this overview of the essential elements of the tax system is to make the point that flattening the tax rates cannot possibly lead to simplification of the structural provisions of the *Act*. Almost all of the detailed technical rules necessary to define the six components of the tax system, other than the rate structure itself (the jurisdictional rules, the tax base, the tax accounting rules, the attribution rules, and the rules of procedure), are unaffected by the rate structure. Legal scholars who work with the detailed rules of the tax system on an ongoing basis are almost unanimous on this point. For example, Boris Bittker, one of the pre-eminent tax scholars in the United States, and author of a comprehensive multi-volume treatise on American tax law, has stated, "having begun my teaching career two decades ago with a conviction that most of the complexities in federal income taxation (especially problems of timing and income-splitting) were indissolubly linked with progression, I am now convinced that proportionality would not contribute very much to simplicity."<sup>76</sup> Michael Graetz, Professor of Law at Yale Law School, and

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76. C.O. Galvin & B.I. Bittker, *The Income Tax: How Progressive Should It Be?* (Washington, D.C.: American Enterprise Institute, 1969) at 33.

former secretary to the treasurer on tax policy, has likewise asserted that, “[c]ontrary to many popular beliefs. . . multiple tax rates are not now a source of very much complexity in the federal income tax.”<sup>77</sup>

The income tax must necessarily consist of technical rules defining the components of the structural tax system. But it also consists of numerous special preferences—often called tax incentives, tax subsidies or tax expenditures—that are departures from the normal tax structure and that are designed to subsidize a particular industry, activity, or class of persons. These special preferences may take one of several forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, nonrefundable credits against tax, refundable credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favoured activities or groups, effected through the tax system instead of through direct grants, loans, or other forms of government assistance. Illustrative tax expenditures include the exemption for one-quarter of capital gains, deductions for child care and moving expenses, deductions for contributions to Registered Retirement Savings Plans (RRSPs), credits for donations to charitable organizations, credits for tuition fees, credits for research and development expenditures, fast write-offs for some corporate capital expenditures, and the low rate of tax for small businesses and manufacturing and processing profits. The Department of Finance accounts each year for the cost of over 100 tax expenditures for individuals and over 50 for corporations.<sup>78</sup>

Many argue that most of these tax expenditures do not serve legitimate government objectives, and to the extent that they do, these objectives could be more appropriately pursued by the use of some other government policy instrument such as direct government spending programmes;<sup>79</sup> however, no matter what one’s view of the merits of tax expenditures there is no question that they enormously complicate the income tax system. For the average person they undoubtedly account for almost all the difficulties involved in filing a tax return. Again, once a taxpayer’s taxable income is determined, applying the tax rates, no matter how many there are, is not difficult. What is difficult is completing the schedules if a taxpayer is claiming the exemption for one-quarter of realized capital gains, the deduction for child care expenses, the deduction for contribu-

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77. M.J. Graetz, “Current Flat Tax Proposals” (1995) 67 *Tax Notes* (May 29) 1256 at 1257.

78. Canada, Department of Finance, *Government of Canada: Tax Expenditures* (Ottawa: Department of Finance, 1998).

79. The leading text on tax expenditures remains S.S. Surrey & P. R. McDaniel, *Tax Expenditures* (Cambridge: Harvard University Press, 1985).

tions to an RRSP, the credit for tuition fees, or any one of the dozens of tax expenditures available to qualifying taxpayers.

Even if the flat tax rate proposal were coupled with a comprehensive broadening of the tax base, under which these tax expenditures were removed from the tax system, it is not obvious that life would be simplified for most taxpayers. The reason for this is that presumably at least some of these tax expenditure programs, if they were removed from the tax system, would reappear as direct subsidy programs. As direct subsidy programs these tax expenditures could be better targeted, more easily enforced, and the government would be more accountable for them and have more control over them; however, there is little question that this substitution of direct expenditures for tax expenditures would complicate life for beneficiaries of these programmes. Instead of simply claiming their entitlement to the programs on a schedule to their tax return, and offsetting the amount of the subsidy against their tax liability, they would presumably have to fill out a separate form to claim the subsidies and await a cheque in the mail. Although the tax system gains in simplicity, overall complexity of government operations would likely increase. The costs of running administratively separate matching grant subsidies for child care expenses, research and development expenditures, tuition fees, charitable donations, and the many other similar programs now delivered through the tax system would probably be much higher than the incremental cost of running these programs through the tax system.

Also, parenthetically, if these tax expenditures measures were repealed it is not clear that their elimination would translate into revenues available for tax reductions, as misleadingly assumed in all flat tax proposals. Not only would some repealed tax expenditures likely be reenacted as direct subsidy programs, since they serve important government objectives, but even if not, government expenditures would inevitably increase. For example, repeal of the tax credit for charitable deductions would undoubtedly lead to an increase in government outlays for educational, cultural and other activities now supported by the voluntary sector; repeal of the current tax exclusion for employer-provided private health insurance and the tax credit for medical expenses would lead to political demands for increased coverage of public health insurance plans. Fundamental reform of the income tax base could not avoid an examination of broader government policy goals in many of the social and economic policy areas now served by tax expenditures.

Thus, as even this brief review of the two elements of the tax system makes clear, the tax system's rate structure has almost nothing to do with its complexity. The major sources of the complexity, uncertainty, and compliance costs of the income tax arise because of the need to measure

taxable income on an annual basis and from the felt political need to use the tax system to pursue social and economic goals through the enactment of tax expenditures. Also, to be brutally frank, in spite of the mileage that flat taxers get out of arguing for a simpler tax system, for most people filing a tax return is simple. The great bulk of the population who live on a wage or salary either pay no personal income tax at all, or already pay tax at a flat rate on their earnings. Moreover, to the extent that claiming a tax credit for charitable donations, for example, complicates filling out their tax return it is likely that taxpayers would be even more unhappy if the credit were eliminated on the grounds that would make life simpler for them. Further, all the talk about letting people file their return on a post card looks a little silly these days when an increasing number of taxpayers file over the telephone or by computer. The irony of attempting to appeal to people's interest in a simpler tax system to justify flat tax rates is that very likely when most people express concern about the complexity of the tax system, what they resent is a tax system that appears so complex that the rich are able to avoid paying their fair share by taking advantage of loopholes in the details of the rules.<sup>80</sup> That is, they want a simpler tax system so that the rich pay more, not less, tax. One of the many tired old jokes that is recycled among tax lawyers is one in which an extortionate government asks taxpayers to fill out a tax return with just two lines: first line—how much do you make over \$50,000; second line—send it to us. This is not a particularly funny joke, even as jokes by tax lawyers go, but it does make the point that the complexity of the tax system has nothing to do with how much tax is collected and whether the rates are low and flat or confiscatory.

## 2. *Reduced Tax Evasion*

A claim frequently made to justify flat tax rates is that lowering income tax rates will lead to less tax evasion. This argument is particularly popular in the business press.<sup>81</sup> In the heady days of supply-side econom-

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80. Researchers have been unable to find any consistent relationships between perceptions of tax equity and tax complexity. G.A. Carnes & A.D. Cuccia, "An Analysis of the Effect of Tax Complexity and its Perceived Justification on Equity Judgments" (1996) 18 *J. of Am. Tax'n Assoc.* (No. 2) 40.

81. For example, in a story headlined, "Flattaxes the way to end vicious evasion circle" *The Financial Post* (21 August 1993) S3, Diane Francis, one of Canada's leading financial journalists, reported that Canadian taxes were too high and urged the government to reduce them in order to "reduce widespread tax evasion . . ." This same reporter wrote a book entitled, *Underground Nation*, in which she blamed the alleged burgeoning of the underground economy in the early 1990s, and most of Canada's other economic ills, on high tax rates and

ics it was often suggested that cutting marginal tax rates could be revenue neutral partly because lower marginal rates would lead to greater reporting of income. As an aside, at some level, arguing that taxes should be reduced to encourage tax compliance is a strange argument. It is a little like arguing that criminal conduct could be reduced by restricting the definition of criminal offences. Of course it could, but at the expense of sacrificing the desired level of social order. It would be interesting to know if those in favour of flat taxes in order to reduce the incentives to evade are also in favour of legalizing marijuana and other drugs because of the difficulties of enforcing their prohibition. The argument has a particularly peculiar ring to it when it is made by the rich themselves or their representatives. It seems somewhat analogous to political blackmail. In effect, they are arguing that their taxes should be reduced since if they are required to pay the amount the democratic majority deem to be their fair share they will subvert the political will by engaging in criminal activity. In any event, even accepting that the argument is made in good faith, the hypothesis that evasion can be reduced by flattening the tax rate is without theoretical or empirical support.

What is the theory that would explain why flat taxes would reduce tax evasion? Those who make the argument presumably reason that as tax rates are lowered the benefits of evasion are reduced and, therefore, taxpayers are less likely to cheat. If, for example, the tax rate is reduced from 50 percent to 30 percent, the benefits of not reporting \$100 of earned income slips from \$50 to only \$30. Since the benefits of cheating are reduced when marginal tax rates are lowered, evasion should be reduced as well.

This simple theory of why people fail to comply with tax laws rests squarely upon the economic account of the criminal mind first developed over 30 years ago by Gary S. Becker.<sup>82</sup> Generally, this approach suggests that criminal activity can be understood as just one more illustration of 'economic persons' attempting to maximize their expected income by rationally evaluating the costs and benefits of any chosen activity. In deciding whether to evade, taxpayers simply weigh the expected benefits of cheating (the amount of income saved by not paying taxes) against the

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other efforts by government to regulate the market economy. D. Francis, *Underground Nation: The Secret Economy and the Future of Canada* (Toronto: Key Porter, 1994). See also T. Corcoran, "Cut taxes to end cheating. Yes, Minister" *The Globe and Mail* (27 November 1993) B2 and "How to get round tax evasion" *The Economist* (28 May 1994) 66 (tax evasion could be reduced by lowering tax rates).

82. G.S. Becker, "Crime and Punishment: An Economic Approach" (1968) 76 *J. Pol. Econ.* 169.

potential costs (the probabilities of detection and conviction, and the penalty). Based upon this rational calculation, and their attitude towards risk, taxpayers will choose to cheat or not.<sup>83</sup>

Although it might seem obvious that, if one adopts the economic explanation for why taxpayers commit tax evasion, increased tax rates are likely to lead to more evasion, in fact, for a number of reasons, the use of this model of criminal behaviour to explain tax evasion leads to the opposite conclusion. Basically, this is because, although higher tax rates increase the benefits of cheating, they also increase the costs, and the costs increase faster than the benefits, hence, according to the Becker analysis tax cheating should be reduced with higher rates.

First, assuming that taxpayers are risk averse, a change in the tax rate will have competing effects on the taxpayer's decision to evade. On the one hand, it will have a substitution effect. Since declaring income becomes more expensive as rates increase (high tax rates leave the taxpayer with less after-tax income than lower tax rates), the taxpayer will be tempted to substitute undeclared income for declared income—cheat more. On the other hand, increased tax rates will also have an opposite income effect. Increased tax rates will reduce the income of taxpayers, leaving them less well off. On the assumption that individuals are risk-averse, and that they become more risk-averse the lower their income (that is, that individuals dislike risk but dislike it relatively less as their incomes rise), increased tax rates will make it less likely that taxpayers would be willing to incur the risks of tax evasion (a higher tax rate reduces net income, causing individuals to be more risk-averse). In the first attempt to theoretically model the tax evasion decision using these economic assumptions about human behaviour, Michael Allingham and Agnar Sandmo concluded that a theoretical economic analysis yielded indeterminant results regarding the effect of tax rates on noncompliance.<sup>84</sup>

Second, the costs of tax evasion increase as marginal tax rates increase not only because of the income effect of higher rates but also because in

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83. The leading text on applying the economic model of criminal behaviour to tax evasion is F.A. Cowell, *Cheating the Government: The Economics of Evasion* (Cambridge: MIT Press, 1990).

84. M. G. Allingham & A. Sandmo, "Income Tax Evasion: A Theoretical Analysis" (1972) 1 J. Pub. Econ. 323. This basic model has been refined by many subsequent analysts, however, the elaborations have not supported the theoretical proposition that lower tax rates will lead to reduced tax evasion. For a review of this research see G.S. Cooper, "Analyzing Corporate Tax Evasion" (1994) 50 Tax L. Rev. 33 at 51-59. But see G. Yaniv, "Tax Evasion and the Income Tax Rate: A Theoretical Reexamination" (1994) 49 Pub. Fin. 107.

most income tax systems, including Canada's, the penalties for evasion are dependent on the amount of tax evaded not the amount of income unreported. Thus as the tax rate increases the penalty incurred for not reporting a fixed amount of income also increases. For example, if a taxpayer does not report \$100 of income when the tax rate is 50 percent, and the penalty is 150 percent of the amount evaded, the penalty will be \$75; if the rate were only 30 percent the penalty would be only \$45. When this qualification is made to the basic economic model described above, that is if it is assumed that fines are levied on evaded taxes rather than evaded income, it has been shown that there would be no substitution effect, hence, higher tax rates should lead unambiguously to reduced evasion.<sup>85</sup>

A third cost to the taxpayer that increases as tax rates increase is the likelihood of an audit. An increase in the tax rates increases the incentives for the tax department to audit since, for a given level of under-reporting, the total tax and penalties collected from an audit will be greater. Using a game theory model, Michael Graetz and his co-authors concluded that if taxpayers and the tax department both adopt a strategy that is optimal in light of the other's strategy, then an increase in marginal rates will lead to increased compliance.<sup>86</sup> The increased incentive the tax department has to audit will dominate the increased potential payoff to the taxpayer when tax rates are increased. Based upon the above considerations, theoretical studies in economics have reached the counterintuitive result that an increase in tax rates should increase compliance: the costs of noncompliance associated with an increase in tax rates outweigh the benefits.<sup>87</sup> However, just as significant in discrediting the hypothesis that reduced rates will increase compliance is the fact that the theory of human behaviour underlying the economic model of crime is too simple. It reflects the utterly impoverished view of human behaviour that underlies much of economic theorizing, namely, that in deciding whether to engage in illegal conduct individuals should be assumed to be perfectly amoral, totally rational, risk-averse utility-maximizers. Others who study criminal behaviour, including tax evasion, such as psychologists and sociologists, note that human behaviour is much more complex than assumed by

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85. S. Yitzhaki, "A Note on Income Tax Evasion: A Theoretical Analysis" (1974) 3 J. Pub. Econ. 201.

86. M.J. Graetz, J.F. Reinganum & L.L. Wilde, "The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement" (1985) 2 J.L. Econ. & Org. 1.

87. The studies are reviewed in most advanced public finance textbooks. See G.D. Myles, *Public Economics* (Cambridge: Cambridge University Press, 1995) c. 12 and J. Cullis & P. Jones, *Public Finance and Public Choice: Analytical Perspectives* (London: McGraw-Hill, 1992) c. 8.



economic models and that moral, social and political dimensions of tax evasion are much more significant in predicting criminal behaviour than economic considerations. Psychologists assume individuals are moral beings with ideas and values of their own and that commands and impulses filter through and are affected by this moral screen. Thus, they have noted that at the very least even economic factors that might influence criminal behaviour, such as the benefits of crime, the size of penalties and the probability of detection, are mediated through individual attitudes and perceptions. Moreover, they have shown that most decisions, including decisions about tax evasion, are not usually governed by maximizing strategies but by rules of thumbs or heuristics or by how individuals frame their decisions. Sociologists tend to see the causes of variation in human behaviour in the structure of the social system. Hence they tend to explain people's actions by examining the forces that impinge on the positions they occupy within the system. Among other things, this means that they extend the basic economic model of crime control by making the point that law is not the only source of punishments and rewards. Taxpayers live and work in society. They have families, friends, and co-workers who are sources of rewards and punishments. These social forces shape behaviour just as effectively as the rewards and punishments administered by the state. Moreover, in deciding whether to comply with the tax law individuals are influenced by their attitudes toward government, views relating to the enforcement of tax laws, views about the fairness of the tax system, contact with Revenue Canada and demographic characteristics. The point is that any realistic account of why people evade taxes would place little weight on tax rate changes. Whatever weight tax rates have in the decision of most individuals to evade tax is likely dwarfed by other more significant moral, social and political considerations. Indeed, to the extent that most individuals would regard flat rates as inequitable, such a change might result in more evasion.<sup>88</sup>

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88. Studies on the determinants of tax evasion behaviour are legion. The leading collections of articles include J.A. Roth, J.T. Scholz & A.D. Witte, eds., *Taxpayer Compliance: An Agenda for Research*, vol. 1 (Philadelphia: University of Pennsylvania Press, 1989); J.A. Roth & J.T. Scholz, eds., *Taxpayer Compliance: Social Science Perspectives*, vol. 2 (Philadelphia: University of Pennsylvania Press, 1989); and, J. Slemrod, ed., *Why People Pay Taxes: Tax Compliance and Enforcement* (Ann Arbor: University of Michigan Press, 1992). A sampling of the recent work of some of the leading researchers may be found in J. Alm, I. Sanchez & A. De Juan, "Economic and Noneconomic Factors in Tax Compliance" (1995) 48 *Kyklos* 3; A.D. Cuccia, "The Economics of Tax Compliance: What Do We Know and Where Do We Go?" (1994) 13 *J. Acct. Lit.* 81; J.S. Carroll, "Taxation: Compliance with Federal Personal Income Tax Laws" in D.K. Kagehiro & W.S. Laufer, eds., *Handbook of Psychology and Law*

Theories of human behaviour suggest that at best tax rates are likely to have a minor effect on compliance. Certainly, it is difficult to postulate a serious theory that would suggest that reducing tax rates would increase compliance. In light of this strong presumption suggested by theory, what does the evidence suggest? Unfortunately, the empirical evidence on the issue is limited and somewhat unreliable. The leading study tending to show that marginal tax rates and noncompliance are directly related remains a study published in 1983, using data from 1969, by an American economist, Charles Clotfelter. Holding a number of taxpayer characteristics constant, he found that those who faced higher marginal income tax rates understated their adjusted gross income by larger amounts than taxpayers who faced lower rates. Thus, he concluded that tax rates should be considered to be “valid instruments for influencing tax evasion.”<sup>89</sup>

Clotfelter’s data sources and methodology have been extensively criticized.<sup>90</sup> Most significantly, since his study was a cross-section across income levels, and since marginal tax rates are mostly determined by income level, his results can be interpreted as simply showing that high-income taxpayers are less compliant than low-income taxpayers. In a subsequent study, Dennis Cox, of the United States Internal Revenue Service, attempted to control for this possible association by undertaking a cross-section study across individuals with the same income but resident in different states.<sup>91</sup> Since individual states have quite different rates of income tax, if marginal tax rates affected compliance then high-income taxpayers in states with high marginal tax rates might have been expected to have lower compliance levels than taxpayers in the same income class but in low marginal tax rate states. Using basically the same data source as Clotfelter, but using data from 1979 and controlling for income, Cox was unable to find any evidence that higher income tax rates increase the rate of tax evasion: “I conclude from all of this that the

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(New York: Springer-Verlag, 1992) c.25; J.G. Cullis & A. Lewis, “Why People Pay Taxes: From a Conventional Economic Model to a Model of Social Convention” (1997) 18 *J. Econ. Psychol.* 305; P.A. Hite, “An Investigation of Moral Suasion and Vertical Equity Arguments on Intended Taxpayer Noncompliance” (1997) 19 *Law & Pol’y* 1; and V. Tanzi & P. Shome, “A Primer on Tax Evasion” (1993) 40 *IMF Staff Papers* 807.

89. C.T. Clotfelter, “Tax Evasion and Tax Rates: An Analysis of Individual Returns” (1983) 65 *Rev. Econ. & Stat.* 363 at 373. He did, however, qualify this conclusion by noting that, “[w]hether... [the compliance effect of reduced rates] should become an explicit consideration in formulating future tax policy depends, of course, on its magnitude, and the estimates in this paper suggest that it probably is not large compared to other objectives.” *Ibid.* at 372-73.

90. See J.A. Dubin, M.J. Graetz, & L.L. Wilde, “Are We a Nation of Tax Cheaters? New Econometric Evidence on Tax Compliance” (1987) 77 *Am. Econ. Rev.* (No. 2) 240 and D. Cox, “Raising Revenue in the Underground Economy” (1984) 37 *Nat’l Tax J.* 283.

91. Cox, *ibid.*

compliance data we have do not reveal a relationship between tax rates and compliance that can be exploited in design of our income tax system.”<sup>92</sup> Other empirical studies have similarly reached mixed or inconclusive results in searching for a relationship between marginal tax rates and compliance.<sup>93</sup>

The important lesson to be drawn from the cumulative evidence of social science research on tax evasion is that neither serious theoretical analysis nor systematic empirical research has been able to find any relationship between tax rates and tax evasion. Casual observation and common sense would appear to support this conclusion. There is no significant correlation between tax levels and evasion activity in countries around the world.<sup>94</sup> For example, Italy, which has one of the largest underground economies has a tax level that is only slightly above the average European country; Spain, which has the second highest level of evasion has below average tax levels. By contrast, Austria, which has one of the smallest underground economies has above average tax levels. Flat taxers often hold up the 15 percent flat tax system of Hong Kong as a system to be emulated, yet the underground economy in Hong Kong is notoriously large. It is the case that tax levels and evasion have both

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92. *Ibid.* at 288.

93. Econometric studies that suggest there might be a positive relationship between tax rates and tax evasion include a series of articles by S.E. Crane & F. Nourzad, “Inflation and Tax Evasion: An Empirical Analysis” (1986) 68 *Rev. Econ. & Stat.* 217; “On the Treatment of Income Tax Rates in Empirical Analysis of Tax Evasion” (1987) 40 *Kyklos* 338; “Tax Rates and Tax Evasion: Evidence from California Amnesty Data” (1990) 43 *Nat’l Tax J.* 189; “Analysing Income Tax Evasion Using Amnesty Data with Self-Selection Correction: The Case of the Michigan Tax Amnesty Program” in J. Slemrod, ed., *Why People Pay Taxes: Tax Compliance and Enforcement* (Ann Arbor: University of Michigan Press, 1992) 167. For studies that suggest that marginal rates have no significant effect on evasion see J. Slemrod, “An Empirical Test for Tax Evasion” (1985) 67 *Rev. Econ. & Stat.* 232; H. Geeroms & H. Wilmots, “An Empirical Model of Tax Evasion and Tax Avoidance” (1985) 40 *Pub. Fin.* 190; and Dubin, Graetz, & Wilde, *supra*, note 90. Experimental studies have also reached contrasting results, compare N. Friedland, S. Maital & A. Rutenberg, “A Simulation Study of Income Tax Evasion” (1978) 10 *J. Pub. Econ.* 107 (finding that in a tax evasion game, evasion increased with the tax rate) with W. Becker, H.-J. Buchner & S. Sleeking, “The Impact of Public Transfer Expenditures on Tax Evasion” (1987) 34 *J. Pub. Econ.* 243 (the propensity to evade was negatively correlated with the perceived level of tax). See generally M.J. Graetz & L.L. Wilde, “The Economics of Tax Compliance: Fact and Fantasy” (1985) 38 *Nat’l Tax J.* 355 at 362 (“The myopic notion that compliance problems would disappear . . . if we would lower tax rates . . . does not withstand even this introductory analysis. Improving tax compliance will almost certainly require further legislative and administrative actions specifically directed toward that end.”).

94. Estimates of the size of the underground economy in various OECD countries can be found in F. Schneider, “Further Empirical Results of the Size of the Shadow Economy of 17 OECD Countries Over Time” Working Paper, Department of Economics, University of Linz, March 3, 1998. Taxes levels can be found in OECD, *Revenue Statistics 1965-1996* (Paris: OECD, 1997) at 75.

increased in industrialized countries over the past 30 years, suggesting a correlation. But there are many other equally plausible explanations for the increase in the size of the underground economy such as shift to services and self-employment, forces of globalization, and increasing levels of unemployment.

Even within the Canadian tax system itself, there is no evidence that those taxes with the lowest or flattest rates tend to have the least amount of evasion. What evidence is available suggests the opposite. The GST is a flat 7 percent tax, yet there was a substantial increase in the underground economy in the early 1990s and at least some researchers have attributed it almost exclusively to the introduction of the GST.<sup>95</sup> Capital gains and dividend income receive preferential treatment within the income tax system. They are subject to a tax rate that is about one-third less than the tax rate applicable to labour income. Yet, although again there is no clear evidence, anecdotal evidence would suggest there is likely much more evasion with respect to these types of income than there is with respect to labour income. In the United States, for example, at a time when ordinary income was taxed at a 50 percent rate and capital gains at only a 20 percent rate, only 40 percent of capital gains were reported.<sup>96</sup> Of course there is no withholding or information return required for capital gains as there is for ordinary income. Yet this makes the point that if there is an opportunity for under-reporting income people will understate such income even if the unreported income would be taxed at a low rate. Finally, contrary to the prediction that would be made by those who argue that if the tax rates were flattened there would be less evasion under the present system, individuals in low rate brackets appear as likely to cheat as those in higher brackets. Again, there is little reliable evidence of how compliance is affected by income level, but a 1993 survey of individuals in the province of Quebec revealed that low-income individuals were more likely than high-income individuals to engage in unreported work.<sup>97</sup>

Finally, if those who push for flat taxes were truly concerned about tax evasion there would be countless obvious steps they could promote to

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95. P.S. Spiro, "Evidence of a Post-GST Increase in the Underground Economy" (1993) 41 Can. T. J. 247 and "The Underground Economy: Toward a More Balanced View of Alternative Methodologies" (1994) 2 Can. Bus. Econ. (no 4) 18. For explanations in addition to the introduction of the GST see R. Mirus, R.S. Smith & V. Karoleff, "Canada's Underground Economy Revisited: Update and Critique" (1994) 20 Can. Pub. Pol'y 235 at 236-238 and D. Drummond *et al.*, "The Underground Economy: Moving the Myth Closer to Reality" (1994) 2 Can. Bus. Econ. (No. 4) 3 at 7.

96. Graetz & Wilde, *supra* note 93 at 360.

97. Survey results reported in Quebec, Commission on Taxation and the Financing of Public Services: Making Choices Together, "The Underground Economy, Unreported Work and Tax Evasion" (Quebec: Les Publications du Quebec, 1996) at 7-9.

prevent tax evasion that would be much more effective than tax reductions; for example, comprehensive withholding requirements for property and business income; requiring withholding on most payments made by businesses to service contractors; the expansion of financial transaction reports and the right and ability to match these and other information returns relating to assets with tax return information; requiring insurance and other companies to report amounts paid to auto repair shops and so on; requiring taxpayers with assets over a certain amount to file balance sheets with their tax returns; increasing the climate for taxpaying by reminding taxpayers of the connection between the taxes they pay and the safe streets, liveable cities, hospitals, schools, and roads they all enjoy; providing penalties for taxpayers who do not disclose questionable positions on their returns; throwing more tax evaders in jail; requiring the public disclosure of corporate tax returns filed by corporations over a certain size; and increasing the number of tax audits.

### 3. *Increased Economic Prosperity*

#### a. *The False Promises of Supply-Side Economists*

Every ill the economy has suffered over the past two decades has been attributed by neoconservatives to high tax rates on rich individuals; the most persistent refrain has been that the present progressive tax system has stagnated the economy and productivity growth. Flattening tax rates would usher in a new era of unconstrained prosperity, they plead.

How might reduced tax rates for rich individuals increase the standard of living of everyone? The precise behavioural mechanisms through which lower tax rates are supposed to unleash unbridled economic growth are sometimes difficult to discern from the musings of flat taxers, however, faced with lower marginal tax rates, it appears to be assumed that (i) the rich will work more hours per week, more weeks per year, and more years per lifetime since the amount they can earn after tax from working will have increased; (ii) they will save more because the government will be taking less of the interest, dividends and capital gains they can earn on their savings; and (iii) rich and talented Canadians will be more likely to remain in Canada and contribute to the economy instead of emigrating to more tax-hospitable countries. The flat taxers make other claims, such as if tax rates are low, more individuals will be encouraged to become entrepreneurs or otherwise make risky investments since they will be allowed to keep more of the resulting profits, and high individual tax rates serve as a signal to international business that the jurisdiction imposing them is unfriendly to business and therefore discourages businesses from locating in the jurisdiction. However, the three enumer-

ated claims are the ones most central to their case and are the ones I will deal with here.

Flat taxers frequently buttress their economic case for lower tax rates with a litany of standard rhetorical flourishes. Alluding to one of Aesop's Fables, they sometimes refer to progressive taxes as killing the goose that lays the golden egg. An analogy to a leaky bucket is another favourite.<sup>98</sup> If a bucket of full of water represents the amount of national income that those who support progressive taxes want to transfer from high-income individuals to low-income individuals, flat taxers make the point that the higher the tax rates the leakier the bucket. Leaks are also caused by administrative expenses, changes to the motivation of recipients, and other factors involved in taxes and transfers that cause reduced work effort. At some point, because there is so much leakage, the attempted redistribution is not worth the effort. The parable that equates national income to a pie is a further favourite. Flat taxers claim that those who support progressive taxes are obsessed with how to slice the pie, and with ensuring that the special interest groups that they represent—like poor children, the impoverished elderly, the sick, students and all other powerful interest groups—get a decent-sized slice of the pie. However, concentrating on slicing the pie into smaller and smaller wedges, results in no growth in the size of the pie. Flat-taxers, by contrast, say they are concerned about the size of the pie. If public policies, such as flat taxes, are enacted, it will enlarge the size of the pie and there will be bigger slices for everyone. In these terms, the critical questions are how much more leaky do higher taxes make the tax/transfer-bucket, or how much larger will the economic pie become if tax rates on high-income individuals are reduced?

The economic arguments that flat taxers make are derived from the familiar, and much maligned, "trickle-down" theory of economics: a tax cut will cause rich people to work harder, save and invest more and thus make everyone better off in the long run. This argument was popularized by the so-called "supply-siders" and had its heyday during the Reagan administration in the United States.<sup>99</sup> Briefly, according to traditional Keynesian doctrine, employment and economic growth are determined

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98. This analogy was developed at length by Arthur Okun, *Equality and Efficiency: The Big Tradeoff* (Washington, D.C.: Brookings Institution, 1975).

99. Writing books on supply-side economics became a cottage industry among many of the entrepreneurs who made up the school. The leading texts were B. Bartlett & T.P. Roth, eds., *The Supply-Side Solution* (London: Macmillan, 1983); G. Gilder, *Wealth and Poverty* (New York: Basic Books, 1981); P.C. Roberts, *The Supply-Side Revolution* (Cambridge: Harvard University Press, 1984); and, J. Wanniski, *The Way the World Works*, rev. ed. (New York: Simon and Schuster, 1983).

by aggregate demand. Unemployment and low rates of economic growth are caused by insufficient spending. Thus conventional Keynesian economics requires government to manage aggregate demand by using fiscal policy to influence the spending of consumers, businesses, and governments. During the late 1970s, when many western economies were suffering from stagflation—high rates of unemployment and inflation—supply-side economists stepped in and argued that the preoccupation of Keynesians with demand had blinded them to the need for analysing the effect of changing tax rates on productivity, investment and incentives to work. They argued that instead of concentrating on demand, governments should concentrate on increasing the supply of goods and services. Although supply-side economics addresses all aspects of aggregate supply, it focuses in particular on the appropriate role of government in encouraging growth through its taxation policies.

There are many versions of supply-side economics; even the most modest version should be discounted. However, it is worth noting that almost no one believes the version that flat taxers often put forward, namely, that by reducing tax rates, tax revenues would significantly increase as individuals work harder, save more and take more risks. John Kenneth Galbraith called it “a relatively sophisticated form of fraud.” Walter H. Heller likened it to laetrile, and James Tobin, Nobel Laureate in economics, termed it “snake oil.” During the campaign for the Republican nomination in 1980, when Ronald Reagan popularised this variant of supply-side theory, George Bush referred to it as “voodoo economics.” When Bush ran for president in 1988, he espoused much the same economic theory. A columnist renamed it “deep voodoo” and said it sounded like “deja voodoo all over again.” Another protested that the economic theory was “giving voodoo a bad name.”<sup>100</sup>

No one doubts the existence of the kind of incentive effects flat taxers postulate. Incentive effects of this kind are the stuff of *Econ 101*, as economists are fond of endlessly reminding us. The question is how important the incentive effects are within a range of reasonable tax rates, and what they add up to in relation to the potential GDP. Although it seems to be almost an article of faith among the converted that high taxes have significant adverse effects on economic growth, this proposition is not obvious in theory, nor is it supported by the weight of empirical evidence.

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100. These and other epithets used by leading economists and journalists in referring to the theory are cited in M. Gardner, *Knotted Doughnuts and Other Mathematical Entertainments* (New York: W.H. Freeman, 1986) c. 21 at 264.

b. *Historical Evidence: High Marginal Tax Rates Have Coexisted with High Growth*

One obvious way to determine whether or not high marginal tax rates affect economic growth is simply to attempt to observe whether there is any relationship between these two phenomena or variables. This might be done by examining changes in tax rates and rates of economic growth over some period of time in one country (if marginal tax rates affect economic growth, then one might expect that when marginal tax rates decline rates of growth would increase) or by comparing tax rates and rates of economic growth across a number of countries (if marginal tax rates affect economic growth, then one might expect that those countries with high marginal tax rates would be floundering while those with low marginal tax rates would be flourishing).

Looking first at changes in marginal tax rates in Canada over the past fifty years, the fact that reductions in the top marginal tax rate have been accompanied by reduced rates of economic growth must at least be a troubling coincidence to those who argue that reducing the top marginal tax rate is the key to spurring economic growth. In the late 1940s and early 1950s, the top marginal tax rate was in excess of 90 percent and in real terms the gross domestic product was increasing at an annual rate of 6.2 percent; in the 1950s and 1960s the top marginal tax rate was in excess of 80 percent and the average annual growth rate was 5.1 percent; from 1972 to 1981 the top marginal tax rate was reduced to about 60 percent and the growth rate slipped to 4.2 percent; since 1981 the top marginal tax rate has been around 50 percent and the growth rate has averaged only 2.4 percent.<sup>101</sup> This time-series correlation between marginal tax rates and growth rates points unambiguously to a negative, not a positive relationship.

Similar experiences have been observed in other countries. In Japan, throughout the whole of the so-called Japanese miracle, when economic growth in Japan was the envy of the world, its top marginal tax rate was over 80 percent. No one has ever accused Japanese executives or workers of taking too much leisure. It was reduced in recent years and Japan has slipped into a recession. Sweden had a very high rate of economic growth throughout the 1960s and 70s and most of the 80s, and its top marginal tax rate was 75 percent and higher. In a major tax reform exercise in 1991,

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101. It is the case that since the 1940s total taxes (and the size of government generally) as a percent of Gross Domestic Product have risen at the same time that economic growth has slowed. Supply-siders sometimes point to these coincident trends as evidence that higher taxes have stunted economic growth. However, it is the marginal tax rate that flat-taxers claim has the most serious effect on productive behaviour.



the Swedish top rate of tax on labour income was reduced to 50 percent and the tax on investment income was set at a flat 30 percent. In the same year, Sweden slipped into its most severe economic downturn since the 1930s. Between 1991 and 1993 its economy shrank by more than 5 percent.<sup>102</sup> In fact, in the late 1980s practically all industrialized countries reduced their marginal tax rates in response to the reduction in marginal rates in the United States in 1986, with disappointing results.

The one historical example that flat taxers frequently refer to as proving the favourable effect of flatter tax rates on economic growth is the tax cuts in the United States in the early 1980s.<sup>103</sup> In 1981, President Reagan reduced the marginal tax rate on investment income from 70 percent to 50 percent and introduced tax cuts that generally lowered the average rates of tax. From 1983 to 1989, the United States experienced a prolonged period of economic growth. The supply-siders attribute this to the tax cuts. However, it is unlikely that the tax cuts were responsible for any of this economic growth.

Since the reduced tax rate on labour income was not substantial, the principal argument the supply-siders made in support of the Reagan tax cuts was that they would result in increased economic growth by inducing high-income individuals to save and invest more. Yet, unfortunately for their theory, the United States private savings rate fell in the 1980s, after being constant for decades. The personal saving rate slid from 5.9 percent in 1981 to 2.5 percent in 1987. The net national saving rate dropped even more, from 6.4 in 1981 to 1.7 in 1987, reflecting the large deficit created in part by the reduced tax rates. There are a number of plausible explanations for the drop in the savings rates over this period that confound any simple comparison between tax and savings rates; however, as Barry Bosworth and Gary Burtless note, "the decade offered a very powerful test of the hypothesis that saving is sensitive to the after-

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102. See J. Agell, P. Englund & J. Sodersten, "Tax Reform of the Century - The Swedish Experiment" (1996) 49 Nat'l Tax J. 641.

103. Some flat taxers also refer to the President Kennedy tax cuts of 1964 as demonstrating the potent effects of tax cuts. However, while the supply-siders argue that the economic boom in the late 1960s that followed the tax cuts resulted from the incentive effects of the cut in marginal tax rates, most economists attribute the impact of the tax cuts to their effect on aggregate demand. They view the tax cut as a successful experiment with expansionary fiscal policy and as a confirmation of Keynesian economics. For an analysis of the 1964 tax cut by one of Kennedy's prominent advisors see A.M. Okun, "Measuring the Impact of the 1964 Tax Reduction" in W.W. Heller, ed., *Perspectives on Economic Growth* (New York: Random House, 1968) 25. Moreover, the extent to which the economic growth that followed the tax cuts would have occurred even without the cuts is unclear since GDP growth averaged over five percent even in the two years prior to 1964. See E. Engen & J. Skinner, "Taxation and Economic Growth" (1996) 49 Nat'l Tax J. 617 at 624.

tax rate of return. Without some convincing new evidence, government policy-makers should act under the presumption that income tax incentives for saving are likely to fail."<sup>104</sup> But more to the point here, whatever the mechanism that lower rates were to operate to produce economic growth, it clearly was not through their effect on savings rates.

The more likely explanation for the record of economic growth in the United States during the mid and late 1980s is simply that the economy was recovering from a deep recession in the early 1980s. Instead of operating on the supply-side, the tax cuts, along with expanding defence expenditures, fuelled an increase in aggregate demand that simply increased the utilization of excess capacity without raising the potential output of the economy.<sup>105</sup> As Paul Krugman observes, if economic growth between the peaks of the business cycle are compared, from 1979 to 1990, the US economy grew at an annual rate of 2.3 percent, which was lower than the growth rates over the business cycle even in the 1970s.<sup>106</sup> There is simply no evidence that the tax cuts did anything to increase the underlying productive capacity of the U.S. economy. In fact, throughout the 1980s, labour productivity, or output per hour worked, was lower in the United States than any other major industrialized country.<sup>107</sup> While tax cuts make rich people richer, they apparently do not make them any smarter.

In extolling the benefits of the Reagan tax cuts, supply-siders frequently claim that household income increased substantially during this period. Economic growth in the United States during the 1980s did translate into increased family incomes, but not nearly as much as might be predicted since productivity growth was so low. Nevertheless, over the business cycle, from 1979 to 1990, the income of the average family did grow by 11 percent. However, quite remarkably, over 70 percent of this rise in average family income went to the top 1 percent of Americans. The income of the typical family (that is, the median family) grew by only 4.2 percent over this period.<sup>108</sup>

Finally, although the United States did experience a period of economic growth during the 1980s, as it recovered from the deep recession

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104. B. Bosworth & G. Burtless, "Effects of Tax Reform on Labor Supply, Investment, and Saving" (1992) 6 J. Econ. Persp. 3 at 23.

105. See C.B. Garrison, "The Defect in Supply-Side Interpretations of the 1960s and 1980s" (1991) 25 J. Econ. Issues 153.

106. P. Krugman, *Peddling Prosperity: Economic Sense and Nonsense in the Age of Diminished Prosperity* (New York: Norton, 1994) at 117.

107. OECD, *Economic Outlook*, no. 48 (Paris: OECD, 1990) at 120. (From 1979 to 1988 the average annual percentage change in labour productivity in the United States was 0.8 percent. Of the G-7 countries, the next lowest rate was for Canada, at 1.4 percent.).

108. Krugman, *supra* note 106 at 136-138.

of 1982, it was not particularly notable. It did not come close to the rate of growth over the business cycle during the economic upturn in the 1960s and did not even match the growth of the oil-shock decade in the 1970s. Moreover, for every year from 1983 to 1989 the rate of real economic growth was greater in the province of Ontario than it was in the United States. In at least three of those years economic growth was almost 2 percentage points greater in tax-weary Ontario than tax-free United States.<sup>109</sup> Throughout this period, taxes were increasing in the province of Ontario, not decreasing.

Of course, these simple time-series correlations are subject to all sorts of confounding variables, and, in spite of the correlation between high marginal rates and high rates of economic growth in recent history in Canada, no one would suggest this correlation implies causation, in other words, that high marginal tax rates on the rich cause economic growth. For that reason, no one takes these one-time coincidences of economic history too seriously. However, they are part of the historical record and at the very least suggest that high tax rates do not appear to have the adverse effects often attributed to them and that they can coexist with high rates of economic growth.

Economists have attempted to use time-series analysis to uncover the effects of taxation on economic growth by using sophisticated econometric methods to control for factors independent of taxes that may affect economic growth and thus isolate the effect of taxes. As might be expected, some of these studies have found that taxes have a negative and statistically significant effect on growth and others have found just the opposite.<sup>110</sup> A problem with all of these studies is attempting to untangle the short-term effect of tax changes on growth in the economy, which might simply reflect the effect of tax cuts associated with deficit spending, and the long-term effects, which might be due to growth in the economy's underlying productive capacity.

### *c. International Evidence: High Taxes Correlate with Productivity Growth*

Time-series studies have many obvious limitations, therefore, analysts have more frequently turned to cross-section studies for evidence of how taxes might affect economic growth. During the past few decades, taxes

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109. Ontario, Minister of Finance, *1995 Fiscal and Economic Statement*, November, 1995 (Toronto: Queen's Printer, 1995) at Table 19, Data Appendix.

110. A number of studies are summarized in P.N. Ireland, "Two Perspectives on Growth and Taxes" (1994) 80 Fed. Res. Bank of Richmond, Econ. Q. 1.

have increased quite dramatically in some countries, while in others they have remained relatively low. If taxes have an effect on economic growth, it should be reflected in different rates of growth across these countries. In recent years, in part because of the increased availability of cross-country data and the development of endogenous growth theory, which suggests that governments matter for economic growth, there has been an explosion of such cross-country studies.<sup>111</sup>

There are countless problems with, and limitations of, these kinds of cross-country studies, which are acknowledged by almost all researchers.<sup>112</sup> First, there are problems with selecting and providing an operational definition for the independent variable. In terms of the present paper, the most relevant independent variable would be marginal tax rates. However, marginal tax rates are difficult to measure appropriately on a comparative basis, therefore, often the studies use a measure of average effective tax rates, or the ratio of total taxes to gross domestic product (GDP), as a proxy. Problems abound even attempting to measure taxes on a comparative basis. What is classified as a tax in one country might be fashioned as a government price in another; some countries include amounts paid by governments themselves as part of the tax burden (for example, sales taxes on purchases), others do not. Instead of taxes, other studies use some measure of government size as an independent variable, for example, total government expenditures, total transfer spending, social security transfers (cash benefits), or social protection expenditures (cash benefits, benefits in kind, and expenditures on public health services). Here again arbitrary budgetary accounting conventions for taxes and spending can result in economically equivalent programs appearing to represent different levels of government involvement in different countries. Also, tax and spending ratios only measure the use of one governing policy instrument; increasingly governments are substituting the use of other policy instruments for taxes and transfers to achieve their social and economic objectives. Finally, all of these tax and

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111. Many of these studies not only examine the effect of taxes on economic growth, but also more generally use cross-country data to investigate the determinants of the long-term economic growth. One of the first studies was R.J. Barro, "Economic Growth in a Cross Section of Countries" (1991) 106 Q.J. Econ. 407. See more recently R.J. Barro, *Determinants of Economic Growth: A Cross-Country Empirical Study* (Cambridge: MIT Press, 1997). An extensive bibliography can be found in R.J. Barro & X. Sala-i-Martin, *Economic Growth* (New York: McGraw-Hill, 1995).

112. See A.B. Atkinson, "The Welfare State and Economic Performance" (1995) 48 Nat'l Tax J. 171 at 196; Engen & Skinner, *supra* note 103 at 636; J. Slemrod, "What Do Cross-Country Studies Teach about Government Involvement, Prosperity, and Economic Growth?" (1995) 2 Brookings Papers on Econ. Activity 373.

spending ratios, as measures of government intervention, completely mask the details and design of the underlying spending programmes and tax systems, even though these details and design features can vary enormously and have significantly different impacts.

A second problem with cross-country studies designed to determine the effect of taxes is that the appropriate measure of the dependent variable, economic growth and prosperity, is not obvious. Should it be simply increases in GDP, real GDP per capita, GDP per employed person, some measure of labour productivity, or some other measure? Moreover, to the extent that all these measures are dependent on GDP as an indicator of a country's economic development and prosperity, they are subject to the well-known critiques of GDP as an economic indicator, including criticisms that GDP excludes the value of leisure, non-market activity and capital services, and includes instrumental expenditures that are not a direct source of economic well-being such as the regrettable necessities of police and defence expenditures and the costs of disamenities such as environmental degradation.

A third problem with these studies is that they tend to be sensitive to the time periods used and the countries chosen to compare. With time periods, it is obviously important that the times chosen over which to make the comparisons do not overlap different stages of the business cycle across countries. A particularly strikingly illustration of the difference that the inclusion of one country can make was an analysis done by the newly elected Conservative Government in Ontario to justify its 30 percent income tax rate reductions. In a chart purporting to demonstrate that tax reductions are associated with faster economic growth, for selected OECD countries the government plotted average government revenues as a percent of GDP from 1960 to 1990 against average per capita real GDP percent growth for the same period.<sup>113</sup> The trend line in the chart suggested that the lower the level of taxes the higher the rate of per capital GDP growth. Japan was a clear outlier on the chart. Over that period, it had low rates of taxes and very high rates of growth. If Japan was removed from the analysis, the trend line actually reversed, suggesting just the opposite of what the government wanted to show.<sup>114</sup>

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113. *Supra* note 109 at 88.

114. Because of Japan's somewhat unique economy, in which, for example, the elements of economic security that are provided by government programmes in other countries are often provided by large corporate employers, its inclusion or exclusion can often have a disproportionate effect in these kinds of analysis and therefore it is often excluded. See P. Saunders, "What Can We Learn from International Comparisons of Public Sector Size and Economic Performance" (1986) 2 *Eur. Soc. Rev.* 52.

Finally, as with all correlational studies, it is difficult to ensure that all factors that might affect the dependent variable, economic prosperity, have been taken into account, and it is difficult to judge the direction of causality. Even if countries with high taxes have also had high rates of economic growth, it might be that some third variable, like industrialization, leads both to higher economic growth and the need for greater government spending, or that rich countries can simply afford to tax more and provide a more generous social security system.

Nevertheless, in spite of the common belief among economists that large governments have a substantially negative impact on prosperity, so far, this empirical program, for all its shortcomings, suggests that the economic costs of high taxes and large governments are insignificant. Individual studies sometimes purport to show that higher taxes lead to lower growth, however, when the cumulative research program is examined it is clear that the weight of the evidence suggests that taxes do not have much effect on economic growth. Instead of reviewing the individual studies here I will simply refer to recent summaries.

Anthony Atkinson, one of England's most distinguished public finance scholars, recently reviewed a number of aggregate empirical studies that attempted to determine whether there was any relationship between the size of government, in particular the amount spent on social transfers, and some measure of economic performance. Of the nine studies he reviewed, two found that government spending had an insignificant effect on annual growth rates, two found a negative relationship (increased transfers reduced economic growth), and three found a positive relationship. He concludes his review by noting that "the results of econometric studies are mixed, and provide no overwhelming evidence that high spending on social transfers leads to lower growth rates."<sup>115</sup> In one of the most thorough reviews of the studies examining the relationship between aspects of a country's tax system and prosperity, Joel Slemrod concludes, "[t]his review of the existing cross-country literature suggests that there is no persuasive evidence that the extent of government has either a positive or a negative impact on either the level or the growth rate of per capita income . . ."<sup>116</sup> In another review, Peter Ireland

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115. Atkinson, *supra* note 112 at 196. Another survey of studies is undertaken by Esping-Andersen, this time of those using a broader definition of welfare state effort - total levels of social spending as a share of GDP. Again, the studies reveal a mix of positive, negative and insignificant effects on national output. G. Esping-Andersen, "Welfare States and the Economy" in N.J. Smelser & R. Swedberg, eds., *The Handbook of Economic Sociology* (New York: Princeton University Press, 1994) 711.

116. Slemrod, *supra* note 112 at 401.

concludes, “a review of the literature reveals that no strong conclusions can yet be reached . . . . A number of papers present evidence that tax rates do affect long-run growth, but others find no significant relationship.”<sup>117</sup> Eric Engen and Jonathan Skinner conclude their review of the evidence with the observation that, “the design of the tax system is likely to exert a modest, but cumulatively important, influence on long-term growth rates.”<sup>118</sup> In a thorough review of the impact of fiscal policy variables on output growth for the International Monetary Fund, Phillip Gerson concludes:

[o]verall, the evidence of these cross-section studies of the effects of tax rates on per capita income growth appears to be contradictory . . . .

. . .

[E]ven if the cross-section studies on the effects of taxes on growth yielded a consensus opinion, it would be wise to treat their results with some caution. In the absence of a consensus, it certainly pays to draw on the results of the substantial body of empirical work that indicates that labour supply decisions - at least of primary workers - savings, and investment are all relatively unresponsive to changes in wages and rates of return, and therefore that the growth effects of most taxes are likely to be relatively small.<sup>119</sup>

As an illustration of the results of some of the cross-country studies on the relationship between taxation and economic growth, Figure 1 plots the relationship between labour productivity growth and the ratio of total taxes to GDP over the past 15 years for 21 industrialised OECD countries. Labour productivity, or output per hour worked, seems like a more accurate measure of a country’s efficiency than GDP since it is a measure of output against the input of effort. At the end of the day, only those increases in GDP which flow from investment in more effective machinery, a more skilled labour force, or better organization of work unambiguously imply greater prosperity from a social point of view. If taxes impaired the ability of a country to increase its prosperity, one would expect to find countries clustered in the bottom right-hand portion of the chart, illustrating that countries with higher-than-average tax ratios tend to have lower rates of labour productivity growth. But no such pattern emerges in Figure 1. Instead, countries are scattered throughout the chart. Some low tax countries had higher than average rates of labour productivity growth over this period, such as Japan and Portugal, but so did some

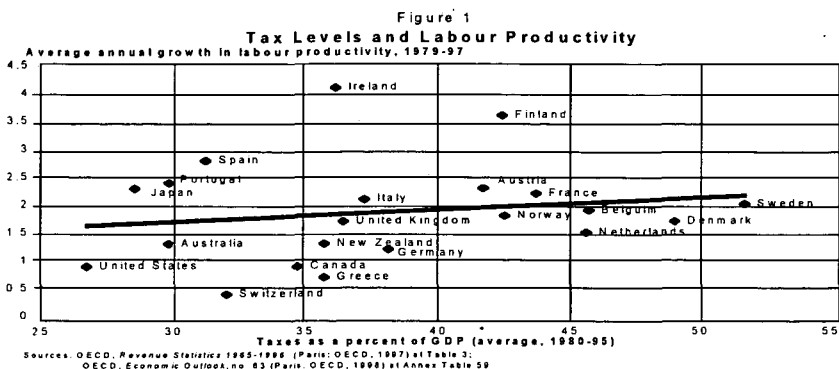
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117. Ireland, *supra* note 110 at 15.

118. Engen & Skinner, *supra* note 112 at 636.

119. P. Gerson, “The Impact of Fiscal Policy Variables on Output Growth” International Monetary Fund, Fiscal Affairs Department, Working Paper 98/1 at 46 [available at <http://www.imf.org>].

high-tax countries, such as Finland, France and Sweden. Indeed, the trendline suggests there is a correlation between higher taxes and higher rates of labour productivity growth, although it is certainly not statistically significant.



Of course not much should be made of a correlation such as this even if it were statistically significant. Because of cultural, demographic or other factors, the rate of growth in Finland, for example, might have been much higher if its taxes were lower, or perhaps at the beginning of the period it started from a much lower level of GDP than most of the countries with lower rates of productivity growth over the period and because of factors unrelated to tax levels it was simply converging with them. Nevertheless, the chart does call into question the simple-minded assertion that high taxes are antithetical to economic growth.

In addition to so-called “top-down” studies that have investigated the association between some measure of the aggregate extent of government involvement in the economy and some measure of economic prosperity, there is a related field of research that has developed over the past few years exploring the political economy of economic growth. Among other relationships, it has explored the relationship between income inequality and economic growth. Contrary to the apparent view of the flat taxers, namely that there is a trade-off to be made between equity and growth, this research has found that equity and growth complement one another. A striking empirical finding of this research project is the appearance of a strong positive relationship across countries between the degree of equality and the rate of long-term economic growth. A substantial



theoretical literature has developed attempting to explain this finding.<sup>120</sup> It appears that inequality has many correlates that are likely to reduce economic growth: political instability and unrest which discourages investment; high crime rates resulting in a diversion of resources towards enforcing law and order and away from more productive use; less investment in human capital because low-income individuals will often be unable to borrow to finance their training and education; lower levels of demand for domestically produced goods and services; a reduction in the general health and therefore productivity of lower-income families; an unwillingness of workers to risk their economic security by engaging in growth-enhancing structural changes; and, low levels of trust and weakened norms of civic cooperation. Much of this research suggests that to the extent progressive taxes and government transfers reduce inequality they will increase, not diminish, the rate of economic growth.

Neither the aggregate historical nor the international evidence provide support for the proposition that high tax rates are detrimental to economic prosperity. Looking at more direct evidence of the effect of taxes on behaviour relevant to a country's rate of economic growth, what is known about the effect of progressive taxes on how hard people work, how much they save and invest, and whether or not they choose to migrate? The evidence is overwhelming that taxes have negligible effects on these choices.

#### d. *Labour Supply: What Causes People to Work Hard?*

Labour income, in the form of wages, salaries and benefits, makes up almost 75 percent of national income; therefore, one of the most significant ways that high marginal tax rates might reduce economic growth is by reducing the amount that people work. This is precisely the argument that flat taxers make. In concluding that high taxes cause individuals to work less, flat taxers are presumably reasoning that if tax rates are high, for each additional hour an individual works the less take-home pay they have, therefore, the less they are likely to work. So, for example, if a

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120. See generally A. Alesina & R. Perotti, "The Political Economy of Growth: A Critical Survey of the Recent Literature" (1994) 8 *World Bank Econ. Rev.* 351; R. Benabou, "Inequality and Growth" in B.S. Bernanke & J.J. Rotemberg, eds., *NBER Macroeconomics Annual 1996* (Cambridge: MIT Press, 1996) 11; A. Brandolini & N. Rossi, "Income Distribution and Growth in Industrial Countries" in V. Tanzi & K. Chu, eds., *Income Distribution and High-Quality Growth* (Cambridge: MIT Press, 1998) 69; R. Perotti, "Growth, Income Distribution, and Democracy: What the Data Say" (1996) 1 *J. Econ. Growth* 149; R. Perotti, "Income Distribution and Investment" (1994) 38 *Eur. Econ. Rev.* 827.

person can earn \$100 for an extra hour of work, and the tax rate is only 30 percent, that will leave them with \$70 after-tax and they might well work the extra hour; however, if the tax rate is 60 percent, then they would only be left with \$40 after-tax and they might decide to watch television instead of working the extra hour.

This result might seem intuitively correct: often individuals complain that with high taxes it is not worth working overtime. However, although some people might be inclined to substitute leisure for work when tax rates are high (referred to in economic jargon as the substitution effect of a price change), an equal number of people might be induced to work even harder in order to earn a sufficient amount of income to maintain, or achieve, their desired standard of living (the income effect of a price change). This result is also intuitive and consistent with commonly observed behaviour. Very likely, the high marginal tax rate will apply not only to the income earned in the extra hour that a person might work, but also to some part of the income they are already earning. In this case, the tax will reduce their income and therefore their standard of living; to maintain their standard of living they will have to work harder. To see the intuitive force of the income effect, consider the result of a reduction in taxes. Flat taxers predict that if taxes are reduced individuals will work harder since they can earn more after tax for each hour worked. But equally plausibly, since the reduction in taxes makes them richer, they might instead take a longer vacation, retire a bit earlier, or go golfing instead of taking on extra overtime. In many ways, a windfall due to a tax reduction is similar to any other windfall such as winning a lottery or inheriting some money. Most people who win a lottery or inherit money do not respond by working harder.

The point is, as every basic economic textbook makes clear, a fall in the after-tax wage rate simply does not lead to an unambiguous prediction about the quantity of work effort supplied. Whereas the substitution effect of a lower real wage could result in a reduction in effort, the income effect pulls in the opposite direction. Economic theory is completely silent on the question of which of these two opposing effects will dominate. The case for the flat taxers' position, therefore, must be made on empirical grounds. Unfortunately, the empirical evidence does not support it.

One of the most telling pieces of empirical evidence that contradicts the supply-siders central claim that higher after-tax wages will cause workers to increase their supply of labour is that throughout most of the 20th century, although after-tax compensation has risen dramatically, the annual labour supply per worker has fallen, not increased. From 1901 to 1981 the standard work week declined from almost 60 hours to less than

40 hours.<sup>121</sup> Furthermore, the participation rate among males has fallen as more men have withdrawn from the labour force and older workers have retired earlier.<sup>122</sup> If the supply-siders' claims about the effect of increased after-tax wages on workers' behaviour were correct, there should have been a significant increase in hours worked over the past century. In fact, it has only been over the past two decades, when wage growth has stagnated, that the decline in hours of work and male participation rates have levelled off.

Countless empirical studies examining the effect of taxes on labour supply have been carried out. These typically take one of three forms: (i) surveys in which workers are asked to give their opinion about the effect of taxes on their work effort; (ii) studies of data involving samples of individuals with different incomes, work effort and other characteristics, in which an attempt is made, using econometric techniques, to estimate the apparent effect of taxes on their work effort; and (iii) social experiments involving situations in which tax rates on individuals have been changed and the effect on their work effort observed.

Killingsworth, in his frequently referred to survey of the empirical studies on the effect of taxes on labour supply,<sup>123</sup> published in the early 1980s, draws a distinction between first- and second-generation studies. The first-generation studies were done in the 1960s and early 1970s using survey data or experimental data derived from the early negative income tax experiments. These sources suggest that taxation has an insignificant effect on the total labour supply of high-income workers. A 1975 OECD survey of the empirical work concluded unequivocally that "the net effect of taxation on labour supply is not large enough to be of great economic or sociological significance."<sup>124</sup> In the second-generation studies, most of which were econometric studies undertaken in the late 1970s and early 1980s, and are often associated with Heckman<sup>125</sup> and Hausman,<sup>126</sup> taxes were found to have a larger effect on labour supply. Two more recent surveys of the studies, each of which emphasize different studies, reach opposite conclusions. John Pencavel's 1986 survey concluded that the

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121. D. Benjamin, M. Gunderson & W.C. Riddell, *Labour Market Economics: Theory, Evidence, and Policy in Canada*, 4th ed. (Toronto: McGraw-Hill, 1988) at 35.

122. *Ibid.* at 31.

123. M.R. Killingsworth, *Labor Supply* (New York: Cambridge University Press, 1983).

124. OECD, *Theoretical and Empirical Aspects of the Effects of Taxation on Labor Supply* (Paris: OECD, 1975) at 126.

125. J. Heckman, "Shadow Prices, Market Wages, and Labor Supply" (1974) 42 *Econometrica* 679.

126. J.A. Hausman, "Labor Supply" in H. Aaron & J. Pechman, eds., *How Taxes Affect Economic Behaviour* (Washington, D.C.: Brookings Institution, 1981).

work disincentive effects of tax rates were small.<sup>127</sup> Jerry Hausman, by contrast, concluded in a 1985 survey that raising marginal tax rates on high-income men led to a considerable adjustment in work behaviour.<sup>128</sup> Thomas McCurdy reviewed both of these surveys and after accounting for methodological problems in the studies relied upon by Hausman, concluded that raising upper-bracket tax rates is likely to induce relatively minor adjustments in men's hours of work.<sup>129</sup> Moreover, more recent studies have been unable to replicate Heckman's and Hausman's findings. They have confirmed the long-standing conventional wisdom that even moderately high income tax rates have little effect on work effort or related matters such as career choices.<sup>130</sup>

In the United States, President Reagan enacted the second of his major tax reform exercises in 1986. *The Tax Reform Act of 1986* reduced the top rate on labour income from 50 percent to 28 percent. This provided an opportunity for researchers to gain some insight into labour supply responses to tax reform. If tax rates have much effect on labour supply it should have been evident from this wonderful natural experiment. However, the results must have been disappointing to supply-siders. The first study on the labour supply response to tax reform was undertaken by Bosworth and Burtless. Remarkably, they found that after tax reform the labour supply of men in the lowest-income categories increased by more than those in the highest-income categories even though the marginal tax rates on high-income men had been reduced and in many cases the marginal tax rates of low-income individuals had been increased.<sup>131</sup>

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127. J. Pencavel, "Labor Supply of Men: A Survey" in O. Ashenfelter & R. Layard, eds., *Handbook of Labor Economics* (Amsterdam: North-Holland, 1986) 3.

128. J. Hausman, "Taxes and Labor Supply" in A. Auerbach & M. Feldstein, eds., *Handbook of Public Economics* (Amsterdam: North Holland, 1985) 213.

129. T. MacCurdy, "Work Disincentive Effects of Taxes: A Reexamination of Some Evidence" (1992) 82. *Am. Econ. Rev.: Papers and Proc.* (No. 2) 243.

130. See T. MacCurdy, D. Green, & H. Paarsch, "Assessing Empirical Approaches for Analyzing Taxes and Labour Supply" (1990) 25 *J. Hum. Resources* 415 at 462 ("The results of this study . . . raise serious questions about the reliability of evidence [Hausman's estimates] cited by much of the literature to support recent tax reform proposals aimed at lowering marginal tax rates . . . According to the estimates [reported in this study] . . . all income and substitution effects are essentially zero."); R.K. Triest, "The Effect of Income Taxation on Labor Supply in the United States" (1990) 25 *J. Hum. Resources* 491 at 512-13 ("The results of this paper suggest that the labor supply of prime-aged married men is relatively invariant to the net wage and virtual income [Triest's results show the income coefficients driven to zero in the maximum likelihood estimations] . . . It seems safe to say that taxation causes fairly little reduction in the labor supply of prime-aged married males in the United States.").

131. *Supra* note 104 at 12.

These results, that tax reductions did not significantly alter the supply of labour for high-income males, was confirmed in subsequent studies.<sup>132</sup>

The Canadian studies have consistently found that both the compensated and uncompensated elasticities of labour supply are small.<sup>133</sup> For example, an econometric study by Eden Cloutier suggests that a reduction of after-tax wages would increase the labour supply of married women in Canada by only two-tenths of 1 percent. The effect was even smaller for men and single women.<sup>134</sup> In a recent exhaustive review of the labour supply research in the United States and Canada, and an analysis of labour supply behaviour in a Canadian negative income tax experiment, Derek Hum and Wayne Simpson conclude:

Although precise measurement of labour supply response is a very difficult problem, and one that economists and econometricians have not yet mastered, we have narrowed the range of reasonable estimates to those that indicate that individuals and families are likely to be fairly insensitive to changes in the tax-transfer system facing them.<sup>135</sup>

In addition to the offsetting income and substitution effects, taxation presumably plays an uncertain role in work behaviour because after-tax income is not the only variable that affects the decision to work. Work can

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132. For example, Nada Eissa, using a micro-data set rather than time series data, concluded that "micro-data from 1976 to 1993 show only weak evidence of a small increased male labour supply response to the TRA of 1986." N. Eissa, "Tax Reforms and Labour Supply" in J.M. Poterba, ed., *Tax Policy and the Economy*, vol 10 (Cambridge: MIT Press, 1996) 119 at 147. See generally, A.J. Auerback & J. Slemrod, "The Economic Effects of the Tax Reform Act of 1986" (1997) 35 J. Econ. Lit. 589 at 600-604.

133. See for example C.J. Eden, *Taxes and Labour Supply of Married Women in Canada* (Ottawa: Economic Council of Canada, 1986); J. Ham and C. Hsiao, "Two-Stage Estimation of Structural Labor Supply Parameters Using Interval Data from the 1971 Canadian Census" (1984) 24 J. Econometrics 133; A. Nakamura and M. Nakamura, "Part-Time and Full-Time Work Behaviour of Married Women: A Model with a Doubly Truncated Dependent Variable" (1983) 16 Can. J. Econ. 229. These studies and others are reviewed in S.A. Rea, "The Impact of Taxes and Transfers on Labour Supply: A Review of the Evidence" in D.W. Conklin, ed., *A Separate Personal Income Tax for Ontario: Background Studies* (Toronto: Ontario Economic Council, 1984) 106, and in L. Osberg, *Behavioral Response in the Context of Socio-Economic Microanalytic Simulation, a report to the Social and Economic Studies Division* (Ottawa: Statistics Canada, April 1986). For an analytical review of tax effects on a number of specific decisions related to labour supply see D.G. Hartle, *A Separate Personal Income Tax for Ontario: An Economic Analysis* (Toronto: Ontario Economic Council, 1984) c.8 at 333 ("The general conclusion of this chapter is that labour supply considerations are important. Nevertheless, the limited information available from the best current research suggests that the labour supply effects of likely [income tax] changes are uncertain and probably fairly small.")

134. E. Cloutier, *Taxes and the Labour Supply of Married Women in Canada* (Ottawa: Economic Council of Canada, 1986).

135. D. Hum & W. Simpson, *Income Maintenance, Work Effort, and the Canadian Mincome Experiment, a study prepared for the Economic Council of Canada* (Ottawa: Minister of Supply and Services Canada, 1991) at 91. See also S. Phipps, "Does Unemployment Insurance Increase Unemployment?" (1993) 1 Can. Bus. Econ. (No. 3) 37.

be a source of enjoyment, satisfaction, status, and power. Noneconomic considerations also have a great impact on choices that indirectly affect a person's labour supply, such as marriage, childbearing, retirement, training, education, and promotional opportunities.<sup>136</sup>

Also, even to the extent that studies on the effect of taxes on the labour supply of workers suggest that workers generally might be somewhat responsive to tax changes, they are likely to be relatively poor predictors of what would happen if tax rates were flattened since they invariably include workers in all income classes; only high-income workers would benefit appreciably from a flattening of the tax rates. A number of considerations suggest that high-income workers are likely to be less sensitive to tax changes than other workers. This group of workers includes people with high ambition who are most likely to derive significant social standing and power from their professional lives. Moreover, if my admittedly limited personal experience with high-income individuals such as tax lawyers and corporate executives is any guide, it is difficult to see how reducing their tax rates could increase their work effort because they are already working long hours. By their own account, these people work harder and longer hours than any other workers. Certainly when one visits Bay Street office towers one does not get a sense of mass malingering. When flat taxers claim that reducing these people's taxes will cause them to work even harder, what are they thinking? Indeed, arguably, if increasing the tax rates caused them to work less the government would be doing them, their families, and probably even the country, an immense favour. Another reason that increased taxes are unlikely to affect the decision of many high-income individuals to work is that much of their income likely reflects economic rents attributable to scarce natural talents.<sup>137</sup>

Finally, aside from the effect of reduced rates on the labour income of high-income taxpayers, there are two reasons for thinking that flattening the tax rates will in fact decrease aggregate labour supply instead of increasing it or even leaving it unchanged. First, since a reduction in marginal tax rates will increase the after-tax return of not only income from labour but also income from capital, it is important to consider what effect an increase in the after-tax return to capital will have on labour

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136. For a discussion of the complex psychological and other factors underlying the decision to work see S.E.G. Lea, R.M. Tardy & P. Webley, *The Individual in the Economy: A Survey of Economic Psychology* (Cambridge: Cambridge University Press, 1987) c. 6.

137. See R. Krouse & M. McPherson, "Capitalism, 'Property-Owning Democracy', and the Welfare State" in A. Gutmann, ed., *Democracy and the Welfare State* (Princeton: Princeton University Press, 1988) 79 at 97.

supply. Here, economic theory is unambiguous. A reduction in taxes on capital income will tend to lower the labour supply since it will only have an income, and not a substitution, effect on the choice of how many hours to work or whether to work at all. In terms of its effect on labour supply, a tax cut on existing capital income is exactly like winning a lottery that pays a prize equal to the reduction in taxes.

Second, if the tax rates are flattened, the marginal tax rates for high-income individuals are reduced, but the marginal tax rates for low-income individuals must therefore be increased to secure the same amount of revenue. A substantial number of low-income workers are likely as unresponsive to tax rates as high-income workers. However, a large number of low-income workers are married women and the empirical evidence suggests that they are more responsive to tax rate changes than men.<sup>138</sup> There are a number of possible explanations for the responsiveness of married women to changes in effective wage rates. First, while men who enter the work force receive strong social approval, married women with children who enter the work force may face social indifference or disapproval. Second, women will often have low-paying service jobs like sales clerking or serving which permit easy exit and entrance. Finally, married women in two-income households are likely to be the low-income earning spouse, and thus family income will be maximized if her contribution takes the form of untaxed, imputed household services. It has been estimated empirically that because of the greater responsiveness of women than men to tax rate changes, a reduction in the progressivity of the tax system that increases the rates of tax on low-income workers is likely to reduce overall labour supply.<sup>139</sup>

*e. Savings Behaviour: What Determines How Much People Save?*

In addition to increasing the labour supply, another channel through which lowering taxes on the rich will lead to greater economic prosperity, according to the flat-taxers, is by increasing the rate of private savings in Canada. A higher level of private saving will lead, it is argued, to a higher level of capital formation. This in turn will make Canadian workers more

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138. The studies are referred to in D. Benjamin, M. Gunderson & W.C. Riddell, *Labour Market Economics: Theory, Evidence, and Policy in Canada*, 4th ed. (Toronto: McGraw-Hill, 1988) at 51-55.

139. P. Apps, "A Tax-Mix Change: Effects on Income Distribution, Labour Supply and Saving Behaviour" in J. Head & R. Krever, eds., *Taxation Towards 2000* (Sydney: Australian Tax Foundation, 1997) 103.

productive and ultimately all Canadians will enjoy a higher standard of living.

This argument for flat taxes rests upon a number of assumptions: that the rate of household savings is low in Canada and should be increased as a matter of policy; that reducing tax rates on the return to savings will increase the rate of savings; that increased savings will lead to increased investment; and, that increased investment achieved by reducing the tax rate on income from capital will lead to a more productive economy. Every one of these assumptions is questionable.

The first link in the argument is that the saving rate in Canada is too low, and should be increased as a matter of policy. In thinking about whether the rate of savings is too low (or too high), it is important to remember that, whatever the rate, whether collectively members of a society should consume less and save more is a value judgment. The trade-off implicit in increasing savings involves reducing the consumption of the current generation to increase the consumption of subsequent generations. The ethical judgment underlying this trade-off might seem uncontentious, particularly if it is being made by the current generation, and if it involves reduced current consumption for those who are otherwise well-off. However, just as likely, if the progressivity of the present tax system is reduced in order to increase savings, the present consumption that is forgone will be that of poor people to whom government transfer payments might be made or that of low-income beneficiaries of public health services and education. The members of the future generation who are most likely to benefit from the increased consumption allowed them, because the consumption of these low-income members of the present generation have been reduced, are likely to be the children of those who are otherwise well-off in this current generation. If it is the poorer members of the current generation who are affected by government policies designed to reduce current consumption, and the children of the rich who eventually benefit, then the value judgment about the need to increase household savings becomes more problematic.

In making the argument for increased saving, business spokespersons often use an undifferentiated “we.” They say things like, “We are enjoying a higher and higher standard of living by our excessive consumption, at the expense of our children.” But in Tonto’s immortal words to the Lone Ranger, “What do you mean ‘we,’ paleface?” The average Canadian worker’s standard of living has hardly improved at all in the last decade—indeed, real wages for workers have declined. By and large it is only the rich who have been enjoying a higher standard of living.



It is easy to feel moralistic about our obligations to future generations, if one is a relatively well-off member of this generation. However, if one is a deprived member of this generation then it is not clear why one should be so concerned about increasing the well-being of future generations. Indeed, it has always struck me as somewhat odd that the economists who purport to be the most concerned about the well-being of future generations are often the same ones who seem to care the least for the most unfortunate members of the present generation.

The second link in the argument that taxes on the rich have to be reduced so they will save more and make us all better off in the long run is that reducing the tax on income from capital will cause high-income taxpayers to save more. But even if the social judgment were made that private savings should be increased, it is unlikely that reducing the tax on income from capital would have that effect.

The difficulty with predicting the precise effect of taxes on savings behaviour is that no one knows for sure why people save. Until that question is answered, it is difficult to construct a coherent theory of saving. Economists generally assume that people save for future consumption. Thus they have developed theories like the "life-cycle" hypothesis and the "permanent income" hypothesis.<sup>140</sup> Under the first hypothesis, people save to produce a level stream of consumption from an income that peaks in midlife. Under the second hypothesis, people save when their transitory income is above their permanent income. These hypotheses concentrate on forms of saving that aim to combat the predictable variations in income over a consumer's lifetime. However, ordinary experience suggests that the savings decision is much more complex than these theories suggest.<sup>141</sup> Such factors as the desire to bequeath, inflation, wealth, habit, cultural norms, availability of credit, quality of public institutions, availability of private and public insurance, and the myriad of reasons why saving might be a goal in itself, all can affect saving behaviour and yet are unaccounted for in the simply "saving for future consumption" models. One way to think about the complexity of the saving decisions is to note that the decision as to what portion of income to save is the obverse of the decision of how much to spend. The decision of how much to spend is typically made after a whole host of

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140. For a description of these theories see any good text on macroeconomics, for example, R. Dornburch, S. Fisher, & G. Sparks, *Macroeconomics*, 3rd Canadian ed. (Toronto: McGraw-Hill Ryerson, 1989) at c. 8.

141. See K.E. Warneryd, "On the Psychology of Saving: An Essay on Economic Behavior" (1989) 10 *J. Econ. Psychol.* 515.

considerations, as every consumer knows from common experience. The fact that savings rates vary dramatically from country to country in a way that cannot be accounted for in standard economic models also illustrates the complexity underlying the psychology of saving. Given the richness of the savings choice, the question must remain empirical and perhaps economists will never be able to bring theory to bear on the data.

The application of price theory to savings behaviour compounds instead of resolves the theoretical uncertainty over whether taxes affect savings behaviour. Price theory leads to a prediction that an increase in taxes on income from savings will increase or decrease or have no effect on the amount taxpayers save. According to basic microeconomic theory, taxation affects household saving decisions in much the same way as it does labour supply decisions: There is a substitution and an income effect. On the one hand, if the tax on savings is reduced, some will save more because the price of saving has been reduced; in effect, because the price is reduced they will substitute more retirement income, for example, for current consumption. On the other hand, if the tax on savings is reduced, some will save less because they will be able to meet their retirement goals with smaller savings. The net effect of the substitution and income effect on savings is ambiguous in theory; therefore, it is necessary to turn to the empirical evidence.

Everyday experience, particularly during the recent stock market boom, would appear to suggest that many people are target savers, that is, they set a specific target for savings in order to achieve a certain level of wealth at retirement. The standard economic life cycle approach to saving assumes that people will attempt to spread their income out over their lifetime to maximize their lifetime well-being, therefore, if they earn more on their investments, or if taxes on their income from capital is reduced, they will spend some now and some will be saved. But increasingly one hears of people anxious to simply accumulate enough money so they can retire. They are not interested in maximizing their income over their lifetime. They appear to have set themselves a living standard that they wish to maintain and then save in order to realize that standard throughout their lives. Naturally, they would prefer to enjoy that standard of living without the need to work. Therefore, providing these people with a tax break, or an increase in the after-tax rate of return they can earn on investments, simply means they will work less, save less, or retire earlier.

A piece of casual empirical evidence that must cause some concern to those who argue that savings are responsive to tax rates is the fact that the savings rates in most countries have remained relatively constant through most of recent history, despite significant changes in interest rates and

other variables. Over the last two decades there have been large changes in real interest rates. In the mid- and late-1970s real interest rates, especially after tax, were often negative. In the 1980s real interest rates rose to levels that were almost unprecedented. Yet the private savings rate did not exhibit such movement or volatility. It seems implausible, therefore, that the response of savings to changes in interest rates is large. As mentioned earlier, in the United States during the early 1980s tax rates on investment income were reduced significantly; new tax incentives were provided for savers; inflation fell, leaving real rates of return at historically high levels; and, there was financial deregulation. According to their proponents, these incentives should have dramatically increased the rate of savings. The surprise is that the private savings rate actually fell in the 1980s after being constant for decades.

Furthermore, if there were a relationship between taxes and savings rates one might expect to find it reflected in the experience of OECD countries. Industrialized countries vary considerably in their relative reliance on overall consumption taxes, on general sales taxes like VATs or retail sales taxes, and on income taxes. Also, there has been considerable change in the use of these taxes in some countries. Yet regressions for a number of years and time periods for each of these measures in conjunction with the national saving rate, the private saving rate, and the household saving rate in each country, reveal no significant relationships.<sup>142</sup>

Consonant with experience and casual empirical observation, the empirical research on the effect of taxes on private savings was, until the 1970s, unanimous in finding that private savings are nearly insensitive to the after-tax rate of return on capital income. Colin Wright summed up the previous work on this question in 1969 by noting that "no evidence exists which supports the hypothesis that the substitution effect upon consumption of changes in the rate of interest is negative."<sup>143</sup> Then, in the late 1970s and early 1980s a few researchers, most notably Michael Boskin<sup>144</sup> and Lawrence Summers,<sup>145</sup> purported to find that reducing top marginal tax rates could have a relatively dramatic effect in increasing

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142. See K. Militzer & I. Ontscherenki, "The Value Added Tax: Its Impact on Saving" (1990) 25 *Bus. Econ.* 32.

143. C. Wright, "Saving and the Rate of Interest" in A.C. Harberger & M.J. Bailey, eds., *The Taxation of Income from Capital* (Washington, D.C.: Brookings Institution, 1969) 275 at 285. See also, A.S. Blinder, "Distributional Effects and the Aggregate Consumption Function" (1975) 83 *J. Pol. Econ.* 447.

144. See M.J. Boskin, "Taxation, Saving, and the Rate of Interest" (1978) 86 *J. Pol. Econ.* S3.

145. L.H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model" (1981) 71 *Am. Econ. Rev.* 533 (finding a savings elasticity of about 2 on the basis not of empirical testing, but of a simulation exercise with a highly restrictive savings model).

household savings. They estimated elasticities in the range between 0.4 and somewhere above 1.0. The findings of Boskin and Summers prompted intense research over the next decade into the empirical magnitude of the relevant elasticity of savings. Their results were challenged by almost every subsequent researcher. Howrey and Hymans<sup>146</sup> checked to see how sensitive Boskin's findings were to changes in the time period for the estimate and to changes in the measure of the rate of return employed. They found his results were not robust. Using several other real rates of return and restricting the time period to the post-war period they found negative interest elasticities of saving.<sup>147</sup> They also made their own estimates and concluded, "[t]here are many good reasons for tax reform, but there is no good evidence to support the view that a positive interest elasticity of loanable-funds saving is one of them."<sup>148</sup> Irwin Friend and Joel Hasbrouck took even stronger exception to Boskin's findings. In the introduction to their study they boldly state: "This paper will demonstrate that there is little scientific justification for the recent literature purporting to show a strong positive interest elasticity of saving. . . ."<sup>149</sup> Barry Bosworth used a specification similar to Boskin's and using data from 1952-80 came up with similar results.<sup>150</sup> But when the period was restricted to 1952-70 the interest elasticity of saving was insignificantly different from zero.<sup>151</sup> Bosworth also notes that his equations, like Boskin's, severely overpredicted savings for the early 1980s. During this period real interest rates went through the roof, while saving rates actually fell. Bosworth concluded, "[a]ssertions that an increase in the return to capital will or will not raise the overall private savings rate must be based on personal beliefs, because the existing empirical evidence must be judged as inconclusive."<sup>152</sup>

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146. E.P. Howrey & S.H. Hymans, "The Measurement and Determination of Loanable-Funds Savings" in J.A. Pechman, ed., *What Should Be Taxed: Income or Expenditure* (Washington, D.C.: Brookings Institution, 1980) 1.

147. *Ibid.* at 13.

148. *Ibid.* at 31.

149. I. Friend & J. Hasbrouck, "Saving and After-Tax Rates of Return" (1983) 65 *Rev. Econ. & Stat.* 537.

150. B.P. Bosworth, *Tax Incentives and Economic Growth* (Washington, D.C.: Brookings Institution, 1984) at 79ff.

151. *Ibid.* at 82.

152. *Ibid.* at 84.

Numerous other recent research studies,<sup>153</sup> the conclusions of several comprehensive literature reviews of studies on savings behaviour,<sup>154</sup> and the conclusion reached by the authors of leading macroeconomic textbooks,<sup>155</sup> have upheld the traditional view that the aggregate savings elasticity is close to zero: personal savings show little, if any, positive response to increases in after-tax returns on investment. As Barry Bosworth has recently noted, "There is only one study that I know of in the U.S. that is able to find a positive effect of interest rates on savings. One outstanding characteristic of it is that no one has ever been able to replicate it and there is no matching result that I know of."<sup>156</sup>

The third link in the argument that lower taxes on income from savings will increase the rate of economic growth is that increased savings will be invested in productive investment in Canada. However, even if the private rate of savings were to increase somewhat if tax rates were flattened, there are a number of reasons for doubting whether this would have a significant positive impact on real productive investment, and

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153. See for example O.J. Evans, "Tax Policy, the Interest Elasticity of Saving, and Capital Accumulation: Numerical Analysis of Theoretical Models" (1983) 73 *Am. Econ. Rev.* 398 (challenges the robustness of Summer's simulation results on several grounds); R.E. Hall, "Intertemporal Substitution in Consumption" (1988) 96 *J. Pol. Econ.* 339 (finding no saving response to increased interest returns and explaining away apparent findings that savings respond to increased interest); J. Skinner & D. Feenberg, "The Impact of the 1986 Tax Reform on Personal Saving" in J. Slemrod, ed., *Do Taxes Matter? The Impact of the Tax Reform Act of 1986* (Cambridge: MIT Press, 1990) 50 (*The Tax Reform Act of 1986* resulted in relatively little change in aggregate personal savings but seems to have had some effect on the composition of personal saving; for example, contributions to IRAs fell drastically after tax reform).

154. B.B. Aghevli, et al., *The Role of National Saving in the World Economy: Recent Trends and Prospects* (Washington, D.C.: International Monetary Fund, 1990) at 20 and 31 ("the weight of the empirical evidence . . . supports the view that the partial correlation between the interest rate and the saving rate is likely to be small, irrespective of the sign" and "on the whole, the effect of taxes on the level of private saving has been relatively small"); A.L. Bovenberg, "Tax Policy and National Saving in the United States: A Survey" (1989) 42 *Nat'l Tax J.* 123, at 128 ("Empirical studies on the interest elasticity of saving generally suggest that interest rates have only a small direct impact on saving in the United States."); R.S. Smith, "Factors Affecting Savings, Policy Tools and Tax Reform: A Review" (1990) 37 *International Monetary Fund: Staff Papers* 1 at 57 ("there are no clear guidelines on how to alter the rate of private saving"); D.A. Starrett, "Effects of Taxes on Savings" in H.J. Aaron, H. Galper & J.A. Pechman, eds., *Uneasy Compromise: Problems of Hybrid Income-Consumption Tax* (Washington, D.C.: Brookings Institution, 1988) 237 at 265 ("While statistical evidence of an association between savings and rates of return can be uncovered, I find the empirical relationship more tenuous than the theoretical arguments suggest.").

155. See for example *supra*, note 140 at 281 ("Typically, research suggests the effects [of a rise in interest rates on saving] are small and certainly hard to find.").

156. B. Bosworth, "The Debate Over Savings" in B.L. Fisher & R.S. McIntyre, eds., *Growth & Equity: Tax Policy Challenges for the 1990s* (Washington, D.C.: Citizens for Tax Justice, 1990) 83 at 87-88.

hence on competitiveness and growth. Some part of increased household savings would be invested in assets such as land, valuable paintings and other collectibles, and owner-occupied housing that do not result directly in the production of additional goods and services. In particular, if there are not enough sound productive investment opportunities in the economy for savings already available, new savings are likely to be used for speculation or investments in items of conspicuous consumption.

More importantly, in a small and open economy like Canada's, there might be little connection between domestic savings and domestic investment because increased savings can flow overseas and finance foreign capital development. Increased saving by Canadians would be put to use financing Canadian investment only if its returns were higher than the returns obtainable elsewhere. If increased domestic savings stayed in Canada, domestic interest rates might fall in the short term. But if they fell appreciably below the international rates, Canadian investors, faced with a low return of funds at home, would simply invest abroad. Conversely, if domestic demand for savings outstrips supply, and interest rates are pushed appreciably higher than international rates, foreign funds will flow into Canada in search of the higher returns, driving the domestic rate down to its appropriate international level. Thus, notwithstanding the domestic savings rate, the increasing internationalisation of financial markets effectively caps the domestic cost of capital. Most analysts have concluded that in an open economy changes in the equilibrium interest rate can largely be ignored because of the elastic supply of foreign savings. Arbitrage between countries will push pre-tax returns toward equality. Consequently, in an open economy such as Canada's, any tax concession for saving is likely only to transfer wealth from those who do not save to those who do. The GNP might rise since the income of savers will increase, but the rate of investment will not change. Accordingly, no other Canadians will benefit from these additional savings.

Finally, even if an increase in domestic savings can affect the cost of capital at home, it is not clear that the cost of capital is an important determinant of new investment. The most important factor a business person takes into account when deciding whether to make a new investment is the expected demand for the firm's products. However, economists have long insisted that, in theory, business investment is determined not only by the expected growth in a firm's sales (the accelerator) but also by the cost of capital (the price of capital goods and the cost of borrowing or otherwise acquiring funds to pay for them). Unfortunately for economic theory, empirically, it has been remarkably difficult to explain actual investment behaviour by changes in the cost of capital.

Like the empirical research on the effect of taxes on both labour supply and savings decisions, until the late 1970s and early 1980s the studies relating to investment decisions were almost unanimous in finding that changes in tax laws had little effect. In their 1985 edition, the authors of the leading macroeconomic text in the United States and Canada asserted:

At least on evidence through 1979, it seems that the cost of capital empirically does not much affect investment and that accordingly the simple accelerator model [investment is determined by demand for output] does as well as the neoclassical model [the cost of capital and expected output determines investment] at explaining investment.<sup>157</sup>

However, in the early 1980s, studies by Martin Feldstein and others<sup>158</sup> purported to show that the cost of capital does affect investment. This caused the authors of the macroeconomic text referred to above to revise their assessment of the evidence slightly in their most recent edition and to admit of some uncertainty in the results of the empirical research.<sup>159</sup> However, still, the most reasonable conclusion from the evidence is that at best the cost of capital has some effect on business investment in plant and equipment but that these effects are modest and occur gradually over a long period.<sup>160</sup> Thus, scepticism is warranted concerning not only the responsiveness of saving to the after-tax rate of return, but also the responsiveness of investment to the cost of capital.

The last link in the chain of argument assumed by the proposition that shifting to a consumption tax will foster economic prosperity is that private capital investment will increase the rate of economic growth. Generally, other things being equal, a country is better off with a larger capital stock. However, the claims made by business groups and right-wing governments about the importance of increasing private investment are often exaggerated.

Growth accounting, a branch of economic research that has attempted to identify the sources of economic growth and measure their effect, has

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157. R. Dornbusch, S. Fischer, & G.R. Sparks, *Macroeconomics*, 2nd Canadian ed. (Toronto: McGraw-Hill Ryerson, 1985) at 277.

158. Referred to in R. Dornbusch, *supra* note 140 at 63.

159. *Ibid.* at 316-17 ("It is clear from the conflicting findings that the evidence is not strong enough to decide the precise relative roles of the cost of capital and expectations of future output.").

160. See *supra* note 150 at 109-110. For more recent studies compare M. Rushton, "Tax Policy and Business Investment: What Have We Learned in the Past Dozen Years?" (1992) 40 *Can. Tax J.* 639 at 640 ("our knowledge of the effects of tax incentives on investment has not advanced in recent years") with J.G. Cummins & K.A. Hassett, "The Effects of Taxation on Investment: New Evidence from Firm Fuel Panel Data" (1992) 45 *Nat'l Tax J.* 243 ("We conclude that there is a significant relationship between the cost of capital and equipment investment.").

been unable to discover a strong association between capital investment and economic performance. In 1957, Robert Solow, in a study that was in large part responsible for his later selection as a Nobel Prize laureate, estimated that over 80 percent of the growth in output per labour hour in the United States had been due to factors other than growth in the input of capital per labour hour.<sup>161</sup> Subsequent studies have confirmed Solow's initial finding that capital accumulation accounts for only a relatively small fraction of productivity growth.<sup>162</sup> For example, in a frequently relied upon study, Barry Bosworth concluded that only 0.1 to 0.2 percentage points of the productivity slowdown in the United States in the late 1970s could be assigned to differing rates of change in the capital-labour rate.<sup>163</sup> According to standard estimates, even a doubling of the U.S. net private investment rate would raise the growth rate of real income by less than half of a percentage point per year. Although there have been studies questioning these results, most notably in work done by Dale Jorgenson and his associates,<sup>164</sup> a recent survey of the literature concludes that the standard model's estimates do not need to be revised upward on the basis of subsequent developments in theory and empirical analysis.<sup>165</sup>

#### f. Migration: What Keeps Talented Individuals in Canada?

The most recent strategy of those who have been advocating lower taxes on the rich has been to invoke the spectre of a "brain drain."<sup>166</sup> Allegedly,

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161. R. Solow, "Technical Change and the Aggregate Production Function" (1957) 70 Q. J. Econ. 65.

162. See for example E.F. Denison, *Trends in American Economic Growth, 1929-1982* (Washington, D.C.: Brookings Institution, 1985).

163. *Supra* note 150 at 29.

164. See D.W. Jorgenson, F.M. Gollop, & B. Fraumeni, *Productivity and U.S. Economic Growth* (Cambridge: Harvard University Press, 1987).

165. M.N. Bailey & C.L. Schultze, "The Productivity of Capital in a Period of Slower Growth" in M.N. Bailey & C. Winston, eds., *Brookings Papers on Economic Activity: Microeconomics 1990* (Washington, D.C.: Brookings Institution, 1990) 369. See also Dornbusch, *supra* note 158 at 648 ("The early finding by Solow that growth in the capital stock makes a minor, though not negligible, contribution to growth stands up well to the test of later research."), and J. Stiglitz, "Comments: Some Retrospective Views on Growth Theory" in P.A. Diamond, ed., *Growth, Productivity, Unemployment: Essays to Celebrate Bob Solow's Birthday* (Cambridge: MIT Press, 1990) 50 at 53 ("These results [Solow's 1957 findings that the rate of savings was likely to have only a small effect on the growth rate of the economy] . . . have held up remarkably well to more than three decades of extensive and thorough investigation.").

166. Traditionally, the phrase "brain drain" was applied to the movement of talented people from developing to industrialized countries. See J.N. Bhagwati & K. Hamada, "ATax Policy in the Presence of Emigration" (1982) 18 J. Pub. Econ. 291.



as a result of the much higher taxes in Canada on high-income, talented and mobile individuals, brainy Canadians have been leaving in droves for the United States. In its 1997 economic survey of Canada, the OECD raised the issue in a chapter on reforming the Canadian tax system;<sup>167</sup> around the tabling of the 1998 federal budget, which much to the disappointment of the flat taxers contained no broad-based tax cuts, the opposition members raised the issue constantly in the House of Commons;<sup>168</sup> and, over the past year, the popular press has shown an abnormal preoccupation with reporting anecdotal stories of high-income Canadians who have migrated to the United States.<sup>169</sup>

Migration is not, of course, a marginal decision: it is an all-or-nothing proposition. People either migrate or they do not. Thus, in making the decision to migrate, what is important to people is not the tax they will pay on the next dollar they earn, but the overall taxes they pay. Consequently,

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167. OECD, *Economic Surveys, 1996-1997, Canada* (Paris: OECD, 1997) c. 4 (Of the many expressions of concern in this chapter about the effect of progressive taxes on the migration of high-income individuals see, for example, at 84: "Some types of labour might be relatively mobile, such as entrepreneurs, executives, or professionals. If so, imposing high taxes on them for, say, redistributive purposes, can be partially frustrated, a consideration that is particularly relevant for Canada because of the proximity of the United States.").

168. See for example *House of Commons Debates* (26 February 1998) at 4469 ("The biggest single looming social issue that threatens the future competitiveness of Canada is our brain drain, the loss of our brightest and best to the U.S."); *House of Commons Debates* (24 March 1998) at 5246 ("What has happened is that we see these Canadian taxpayers, these geese who are laying these golden eggs, looking to the south. They are starting to say 'We are Canadian geese. We do not want to go south, but unfortunately we are being forced to consider this option because we have mouths to feed.' They have all these goslings that have to be looked after. They have to feed the people they are responsible for. They are starting to cast about for other alternatives."); *House of Commons Debates* (26 March 1998) at 5397 ("We need tax relief to keep our best and brightest in Canada and to stop the brain drain that is sapping the lifeblood from Canada's future."); *House of Commons Debates* (26 March 1998) at 5384 ("we have a number of members in this House who have had family members flee the country as economic refugees because they not only cannot find jobs here but, even if they do find a job here, the taxes are so much higher than in a similar job in another country. Many of us have seen friends go to the United States where it has taxes that are about one-third less than what we have in Canada."); *House of Commons Debates* (2 April 1998) at 5687 ("We have heard a lot about brain drain. It devastates Canada's sustainability as a technology leader. It deprives Canadian industries of the ability to remain competitive. Above all, and what we can never forget, is that brain drain rips the heart and soul out of Canada and its families."); *House of Commons Debates* (2 April 1998) at 5687 ("If the finance minister wants to become Prime Minister of this country he should realize that we have to be competitive on a tax basis with the United States or we are going to continue to lose our best and brightest to the United States.").

169. See for example Editorial, "Smart way to stem the brain drain" *The Financial Post* (16 May 1998) 20; C. Goar, "Grads need reasons to stay in Canada" *The Toronto Star* (6 June 1998) C2; M. Janigan, "The tax wars: pressure on governments to cut rates is rising" *Macleans* (8 June 1998) 22; and N. Nankivell, "Brain drain reason enough to cut taxes" *The Financial Post* (11 June 1998) 21.

anxiety about the effect of taxes on migration does not reflect a concern about the progressivity of marginal income tax rates, but a concern about the overall level of taxes or a concern about the progressivity of average rates of tax.

It is the case that overall tax levels in the United States are lower than in Canada. The OECD reports that in 1995 total taxes in Canada were 37.2 percent of GDP, while in the United States they were only 27.9 percent.<sup>170</sup> Unless the United States tax system were substantially more progressive than the Canadian tax system, one would expect that generally high-income individuals would pay less tax in the United States than in Canada. Nevertheless, press reports often overstate the differential by comparing, for example, the top combined federal and provincial income tax rate in Canada, about 50 percent, with the top U.S. federal income tax rate of about 40 percent. For one thing, although 7 states do not have personal income taxes, the rest do, and the highest marginal rates in the various states range from 5 to 11 percent, with an average of about 7 percent. Also, the American income tax system has numerous "phase-outs" that substantially increase marginal rates over middle-income earners and the average rate of high-income earners. The best known is the phase-out of the 15 percent bracket, but, in addition, the following tax concessions phase-out: the personal exemption, the deduction for contributions to IRAs, the ability to claim net losses attributable to certain passive activities, and the child-care tax credit. As well as these explicit phase-outs, the floor under a number of deductions, such as the deduction for investment and employee business expenses and medical expenses and casualty losses, can give rise to implicit phase-outs. Also, the U.S. has higher social security taxes than Canada. Further, it has a wealth transfer tax that falls exclusively on high-income individuals. Tax comparisons are notoriously difficult to make and often depend upon the individual circumstances of the taxpayer. Nevertheless, although individuals are likely to pay less tax in the U.S. than in Canada it is not as much as often contended.<sup>171</sup>

Moreover, in addition to the taxes they pay, in deciding whether to migrate individuals presumably consider the benefits they receive from their taxes. Many goods and services that are paid for through taxes in

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170. OECD, *Revenue Statistics 1965-1996* (Paris: OECD, 1997) at 75.

171. Professional athletes sometimes complain that taxes in Canada are higher, but in fact professional tax advisors contend that with tax planning the amount paid in taxes by professional athletes in Canada is about the same as that paid in the U.S. See T. Van Alphen, "Athletes have got it wrong, say tax advisers" *The Toronto Star* (2 March 1998) D1.

Canada must be purchased in the private sector in the United States. Health care services are an obvious example. In addition to goods and services that provide direct benefits, higher taxes also purchase less tangible benefits such as safe streets, liveable cities, economic security and a more equal distribution of income and wealth, all of which are valued even, presumably, by high-income individuals. That is to say, while it might be true that taxes are higher in Canada than in the United States, many people are likely to find their Canadian taxes to be good value. A low-tax country may actually be unattractive to individuals if low taxes mean an inadequate supply of public goods and services that people value.

Sociological studies on migration behaviour suggest that the primary motive for moving is job related. Some people move because of quality of life factors, some move to be closer to friends and relatives and a few might move because they receive too few benefits from government in relation to the taxes they pay, but most move because of employment opportunities.<sup>172</sup> This finding would appear to be supported by most of the anecdotal evidence reported in the press about the “brain drain.”

Typical of the press stories is one by Edward Greenspon, *The Globe and Mail*'s Ottawa bureau chief.<sup>173</sup> In reporting that high-skilled workers are leaving because of high taxes in Canada, he relied mainly upon Herb Grubel, a right-wing economist at Simon Fraser University, former MP and Reform Party finance critic, and a fierce tax fighter. In the story, the only expatriate he quoted as saying that he left because of taxes in Canada was Herb Grubel's son, a corporate manager who claims he moved from Toronto to Los Angeles because of the lower taxes and mortgage-interest deductibility in the U.S. However, even he conceded that if it were not so expensive he would like to move back to Canada since “Canada is such a great place . . .” Parenthetically, it might have occurred to him that it was the public services that in part made Canada “such a great place.” Professor Grubel's son's step-sister, who was also interviewed for the story, and had moved to Los Angeles to further her career as an animator, said that she only moved because of the job opportunities and added that, “I would rather pay the extra taxes if I knew that people would be better taken care of down here. I think there are some quite awful things that happen here in terms of people not being able to get proper medical

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172. For a summary of the studies see A.C. Michalos, “Migration and the Quality of Life: A Review Essay” (1997) 39 Soc. Indicators Res. 121.

173. E. Greenspon, “Why some of our brightest are heading south” *The Globe and Mail* (28 February 1998) A1.

treatment and the disparity between very rich people and very poor people.” She went on to say that she prefers the more equal distribution of wealth in Canada and that, “I would pay more taxes if I could be back in a system like that. But there are just more possibilities down here for me to work in my business.” Almost everyone else referred to in the story claimed that to the extent there was increased emigration of skilled Canadians to the U.S. it was largely because of the job opportunities.

Recent news stories have reported an increasing number of young lawyers going to New York.<sup>174</sup> Some are attracted by the larger salaries in New York, but many apparently go to New York not for the money, but because they feel that the legal work in New York will be more challenging and exciting. New York is one of the world’s major financial centres. The New York law firms tend to be involved in the largest corporate mergers and acquisitions and the most innovative corporate financing deals. Many have offices around the world. Basically, it appears that Canadian law students are going to New York for the same reasons that dedicated law students interested in corporate law from all over the United States migrate to New York and law students sometimes leave smaller cities in Canada and migrate to Toronto. In the same way that reducing taxes in Halifax will not halt the movement of some students with an interest in business law to Toronto, reducing taxes in Toronto will not halt the movement to New York.<sup>175</sup>

Medical and health professionals have also been reported to be migrating in increasing numbers to the United States. But again, flattening the tax rates would do little to keep them in Canada. The suggestion from the interviews with doctors reported in the press is that they leave Canada not because of the taxes but to engage in more advanced and sophisticated research in the United States<sup>176</sup> and because of the uncertainty, frustration and anxiety created by the hospital restructuring and cut backs in health funding in Canada.<sup>177</sup> Amounts spent on health research at some large United States hospitals are alone greater than that spent by the federal government. Federal government health spending in

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174. A. Keller, “Bidding adieu to the best and brightest” *The Globe and Mail* (15 August 1998) D1.

175. For another story about Canadians leaving for New York for the “risk-taking and adventure” see K. Kenna, “Canadians take a shine to the Big Apple” *The Toronto Star* (5 July 1998) A1.

176. C. Abraham, “Canadian doctors take their talent south: top doctors are moving to U.S. hospitals that offer unlimited research money and a chance to practice cutting-edge medicine” *The Globe and Mail* (11 July 1998) A1; Editorial, “Stingy budgets uproot medical stars” *The Toronto Star* (13 August 1998) A20.

177. L. Papp, “Top gene scientist heading to the US” *The Toronto Star* (5 August 1998) A1.

the United States rose from \$40 per capita in 1991 to \$67 in 1997 while over the same period it fell from \$8.70 to \$8.20 per capita in Canada.<sup>178</sup> The Canadian Medical Association claims that the exodus of doctors is caused in large part because “doctors feel thwarted by closed hospitals, outdated and insufficient equipment and research cuts.”<sup>179</sup> Moreover, to some doctors medical practice in the U.S. is simply more exciting. One doctor described to a newspaper reporter how on his first day at a New York hospital, “he followed the chief resident surgeon around the emergency room half giddy with excitement. There were gunshots and stab wounds and operations right through the crazy New York City night, and he thought, ‘Wow. This is wonderful.’”<sup>180</sup> Does Canada really want to create the apparent conditions that make doctors giddy with excitement in order to keep them here! Large numbers of nurses have left Canada in recent years, but no one has suggested that they have left because of taxes in Canada. They have left because they could not find work in Canada, due in large part to government cutbacks for health services.

It appears that, somewhat ironically, many of those who stand to make the most important contribution to Canada’s future—research scientists, mathematicians and physicists - have been leaving in the past few years, not because of low after-tax salaries in Canada, but because of the government’s refusal to fund basic research or to otherwise show a public commitment to Canadian science and technology.<sup>181</sup> Even in newspaper stories written as part of the campaign to try to convince the government to lower taxes the people interviewed often confess that it was lack of funding and better job opportunities that lead them to the U.S. For example, in a story headed, “Why a top B.C. researcher joined the brain drain,” the migrant, Dr. Christian Fibiger, who left the University of British Columbia to join U.S. pharmaceutical giant Eli Lilly, although he took the opportunity to rail against the Canadian tax system, stated that, “money was not my primary reason for my leaving. My primary reason was the opportunity. I can live my scientific dreams and aspirations here.”<sup>182</sup> A survey undertaken for the Canadian Advanced Technology Alliance asked over 1,000 high-tech workers to identify the factors that were most important in luring them to their current job. The most

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178. Editorial, *supra* note 176.

179. T. Harper, “Ottawa blamed for doctor exodus: cutbacks trigger a brain drain, CMA charges” *The Toronto Star* (10 June 1998) A3.

180. C. Abraham, *supra* note 176 at A8.

181. P. Gessell, “Public Service cuts gut federal science programs” *The Ottawa Citizen* (8 June 1995) A2 (“The downsizing of the public service has devastated many of the government’s science programs, contribution to a brain drain . . .”).

182. D. Francis, “Why a top B.C. researcher joined the brain drain” *The Financial Post* (21 July 1998) 11.

important was a challenging job, followed by exposure to new technology, career opportunities, work environment, and training and development. Salary was the sixth most important factor.<sup>183</sup>

The factors that influence migration decisions has been the subject of microeconomic modelling and some empirical research as it relates primarily to inter-provincial or inter-state migration.<sup>184</sup> Since there are no formal restrictions on the geographical mobility of households between sub-national government levels, if tax differences were a significant factor in explaining migration behaviour one might expect it to be evident in decisions to migrate between provinces, but such appears not to be the case. For example, in Switzerland, where the main progressive taxes are state and local taxes, and where owing to the small size of the country taxpayers can easily move from places with high to places with low taxes, in a recent empirical study, Gebhard Kirchgassner and Werner Pommerehne conclude that although taxes play a small but statistically significant role in explaining where high-income tax payers reside, more important factors are the strong service orientation in the local economy (an index of job opportunity for high-income individuals) and large stocks of infrastructure (an index of the attractiveness of the region).<sup>185</sup>

In a thorough review of the empirical studies dealing with inter-provincial migration induced by changes in Canadian provincial government expenditure or tax policies, Kathleen Day and Stanley Winer found that there is some evidence that such policies as the generosity of the unemployment insurance system influence interprovincial migration flows, particularly among lower-income families, but that “[i]n any given year, most moves appear to be determined by employment and

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183. P. Brethour, “Canadian lifestyle not enough to keep tech types” *The Globe and Mail* (10 June 1998) B27.

184. The early research is summarized in D.G. Hartle, *A Separate Personal Income Tax in Ontario: An Economic Analysis* (Toronto: Ontario Economic Council, 1983) at 302-313, 332 (“There is some initial evidence that migration is responsive to taxes. But research on tax-induced migration is still in the initial stage.”).

185. G. Kirchgassner & W.W. Pommerehne, “Tax Harmonization and Tax Competition in the European Union: Lessons from Switzerland” (1996) 60 *J. Pub. Econ.* 351 at 353. (The Swiss Statistical Office calculates indexes of tax burden on individuals for each canton as a percent of the national average. In 1990, the index of personal income and property taxes varied from 54.8 in the canton of Zug to 150.5 in the Valais. Thus, “a family with two children earning a taxable income of SFr200,000 had to pay SFr18,223 state and local income taxes in Zug, but SFr41,944 in Solothurn, two cities within a distance of less than 100 km. Although this is likely an extreme case, the dispersion of both income and property taxes across the 26 Swiss cantons has remained relatively stable over time.”).

income considerations, rather than by attempts to profit from fiscal surpluses.”<sup>186</sup>

The most comprehensive international study on the effect of taxes on migration decisions was undertaken by the Institute for Fiscal Studies in the United Kingdom. In the U.K. during the 1970s there was concern that reduced earnings and increased taxes were adversely affecting British industry by making it difficult for companies to recruit and retain senior executives. However, a survey of corporate executives, undertaken at the Institute for Fiscal Studies, concluded that, “changes in the income and tax levels of senior staff in the United Kingdom during the 1970s had very little impact on their ability to retain, recruit, or transfer the managers required to fill senior positions.”<sup>187</sup> Though during the mid-1970s there were claims in the popular press that over a quarter of senior managers were seriously considering moving abroad, the survey found that only a few left, and the number that left about equalled the number who returned to the U.K. during that time. The authors hoped that the results of their survey would “lay to rest the widespread fears raised in the late 1970s about the consequences of pay and tax levels of Britain’s senior managers.”<sup>188</sup> They also noted that their survey provided little evidence showing that the recently elected Conservative Government’s policies lifting restrictions on pay and lowering tax rates would have any beneficial effect on British industry.<sup>189</sup> A review of the studies in Continental Europe also concluded that “the mobility of workers between member countries of the EC is not likely to be very sensitive to differences between countries in social benefits or after-tax pay.”<sup>190</sup>

Finally, one has to ask bluntly, even if some high-income individuals emigrate to the United States in response to higher taxes, is the loss to Canada so serious that Canadians ought to yield to the pressure their emigration creates and refashion their public policy to accommodate them? In considering this question the point that needs reemphasis is that, in theory, the threat of emigration introduces a constraint not on the progressivity of the tax system, but on the total degree of redistribution that a country can hope to achieve by the combined effect of taxation and

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186. K.M. Day & S.L. Winer, “Internal Migration and Public Policy: An Introduction to the Issues and a Review of Empirical Research on Canada” in A.M. Maslove, ed., *Issues in the Taxation of Individuals* (Toronto: University of Toronto Press, 1994) 3 at 50.

187. C.G. Fiegehen & W.B. Reddaway, *Companies, Incentives and Senior Managers* (Oxford: Oxford University Press, 1981) at 92.

188. *Ibid.* at 101-102.

189. *Ibid.*

190. J. Ermisch, “European Integration and External Constraints on Social Policy: Is a Social Charter Necessary?” (May 1991) *Nat’l Inst. Econ. Rev.* (no. 136) 93 at 104.

public expenditure. That is to say, the threat of emigration constrains not just the design of one policy instrument of government but one of the most fundamental choices to be made by a society—what is the socially acceptable distribution of income and wealth.

In thinking about how serious the emigration of some talented individuals is, it is worth noting that even with the increased emigration to the United States, except for health professionals, Canada remains a net importer of skilled workers from the rest of the world. Ivan Felligi, the head of Statistics Canada, has estimated that between 1986 and 1996, the inflow of knowledge workers into Canada outstripped the outflow by a ratio of 4 to 1.<sup>191</sup> Relying upon Statistics Canada data, Carol Goar of *The Toronto Star* concluded that Canada gains nine knowledge-sector workers through immigration, the vast majority from the Pacific rim, for every one it loses.<sup>192</sup> After an extensive survey of Canadian-based Chief Executive Officers in 1996, an executive search company concluded that “companies do not seem to have any significant number of executives leaving Canada to work for companies in foreign countries.”<sup>193</sup> It went on to note that, in any event, “any Canadian ‘brain drain’ is offset by Canadian companies recruiting foreign executives to work in Canada.”<sup>194</sup>

For many of the rich people who leave Canada, there is little evidence that they make much of a contribution to a country’s well being. Lawyers, for example, have been accused of being primarily concerned with rent-seeking rather than wealth creation and, in sufficient numbers, of being detrimental to a both a country’s economic growth and its democratic institutions.<sup>195</sup> Should the work of Canadian medical professionals, researchers and scientists residing in the United States prove successful, its results can be readily imported for the benefit of Canadians. Investors who leave Canada will presumably continue to invest here if there are opportunities to make a profit. Rich people who leave Canada and decry taxes often have an exaggerated sense of their importance to the well-being of other Canadians.

Some individuals prefer a society in which there is a high degree of public provision, social cohesion, and a large degree of economic security. Others prefer one in which most goods and services are allocated on the basis of prices established in markets. One purpose of liberalizing

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191. Quoted in E. Greenspon, *supra* note 173 at A10.

192. C. Goar, *supra* note 169.

193. Cambridge Management Planning, “‘Executive Brain Drain’: Foreign Executive Recruitment Survey Results” (Toronto: Cambridge Management Planning, 1996) at 4.

194. *Ibid.*

195. See L.H. Silberman, “Will Lawyering Strangle Democratic Capitalism?: A Retrospective” (1998) 21 Harv. J.L. & Pub. Pol. 607 and the references cited there.



rules of migration is to allow individuals to seek out those jurisdictions where taxation and public expenditures, for example, conform to their preferences. Thus if some individuals move because they are unhappy with the net benefits they receive from government in Canada, it would be a terrible mistake to attempt to address that by making Canada more like the United States. The great majority of Canadians prefer the social and cultural life of Canada to that of the United States. It would be ironic if the government were to respond to the emigration of a few by attempting to make Canada more like the United States. At some point, the two countries would be so much alike that all mobile Canadians would move since they would see little reason to put up with the cold weather. If rich Canadians prefer United States society, and do not wish to remain and attempt to democratically persuade other Canadians to adopt their view, then they should leave. It would be odd to allow their departure to cause Canadians to rethink their collective aspirations when the force of the emigrants' arguments could not.

### *Conclusion*

The arguments that flattening the tax rate will simplify the tax system, lead to less tax evasion, and generate new found economic prosperity, are without support. They are so obviously without merit, that I rather suspect that even those who propound them do not take them seriously. Instead, they likely support flat taxes largely because they feel that progressive taxes are the moral equivalent of stealing from the rich and that the type of society implied by large inequalities in the distribution of economic resources is to be preferred to one in which resources are distributed more equally. Flat taxers are even more plainly wrong about these normative issues than they are about the conceptual and empirical grounds that ostensibly underlie their support for flat taxes. This essay is already too long. However, in conclusion, since at the end of the day they are so central to tax issues such as the rate structure, and to provide some context for the conceptual and empirical questions, these normative issues should be clarified.

One of the fundamental differences between those who support flat taxes and those who support progressive tax rates comes down to their respective views on the ethical justification for the market distribution of income. On the one hand, those who support flat taxes presumably feel that the market distribution of income is just: people deserve their good fortune in our society. Hence, there is no ethical justification for collective action that reduces the amount that people earn in the market place, but if it must be reduced to provide for public goods then it should be reduced

in proportion to their income. On the other hand, those who support progressive rates are likely to feel that the market distribution has no ethical justification and that the state should use the tax system to achieve a more socially acceptable distribution of income. The only income that individuals have any kind of moral claim to is their post-tax income.

Those who support progressive taxation as an instrument for redistributing income on these grounds do not necessarily deny the utility of markets or the institution of private property. It is surely possible to argue that the free market's distribution of income is not just, but at the same time concede that markets are the best way to coordinate the exchange of goods and services in order to maximize their production and perhaps even individual freedom. It is surely not inconsistent to argue that to the extent that the rich can engage in a form of extortion, by withholding services or capital, payments to them might be necessary, but that does not make them just.

This article has no pretensions. Thus, it is not my intention to critically review or even summarize, let alone purport to resolve, the many hundreds of years of debate over whether or not there is any ethical principle that would support the market distribution of income; however, since my support for progressive taxation, and my opposition to flat taxes, rests largely on the grounds that there is not, I will briefly summarize my position. Many theories of distributive justice challenge the justness of the market distribution of income; however, the simplest way of briefly showing that the market distribution of income is unjust is to deal directly with the intuitions that are commonly relied upon in defending the market distribution of income. There would appear to be two such intuitions.

First, one intuition that suggests the market distribution of income is just rests upon the assumption that people's earnings are a measure of the value of their contribution to the social welfare and therefore their personal desert. However, to be at all persuasive there are a number of obvious problems such a theory would have to overcome, to list just a few: the value of individual contributions to social welfare are impossible to determine since all contributions are of an intrinsically social nature and all income is cooperatively generated, therefore, the rules of property and contract cannot sensibly distinguish between individual contributions in the production of goods and services; the demand side of the labour market does not reward skills that are socially valuable but skills that individuals with money demand; in the same way, the supply side of the market does not reward skills that are valuable or admirable but skills that are scarce; large earnings are often the result of morally irrelevant factors because the contributor has no control over them, such as the accident of being born into a family of wealth, the chance event of being

raised in a wealthy country, the good fortune of remaining able-bodied and working for a firm that remains profitable and in Canada, the good luck of investing in the right stock, or the fortuity of being born with an inherited talent that is in scarce supply; and finally, even if an individual's contributions were morally relevant in determining the amount to which they should have a moral claim, in real markets, factors such as social conventions, discrimination, monopoly power, and government regulation are much more likely than productivity to determine the size distribution of income.

A second intuition underlying the notion that the market distribution of earnings is presumptively just rests upon the judgement that the process by which earnings are distributed appears to be fair. However, this process-claim arbitrarily assumes that the initial distribution of income and wealth is just; that people only have property and not broader social rights; that the marketplace in which people trade is free (that is, that people's choices are always fully informed and non-coerced) and neutral (that is, that the rules that define the marketplace do not favour some over others); and, that individuals only have entitlements to goods and services allocated through markets but not to those allocated by other social forms of organization. None of these assumptions is easy to support.

The other fundamental difference that likely separates flat taxers and those who favour progressive taxes is a view about what constitutes the good society. Flat taxers are likely to feel that the individual is the basic unit of society, that individuals differ significantly from one another, that some are inherently more motivated, competent, and self-reliant than others and that the good society allows for, encourages and rewards these differences. Those who support progressive taxes are more likely to emphasize that a good society is one in which everyone is entitled to equal respect, that there should be some measure of solidarity among citizens, that equal membership in society is required to sustain a democracy, and that these values can only be achieved if economic resources are relatively equally distributed.

A progressive tax system itself cannot turn back the rising tide of inequality. It will take concerted action on every front, including enriching earlier childhood education, providing increased economic security and bargaining power for workers, glutting high-skilled labour markets with university graduates and so on. But a progressive tax system is an important instrument for reducing inequality. Moreover, it serves the important symbolic function of reminding people that in our society we do not necessarily think that, for example, the head of a beer company is worth more than over 100 nurses, or that the head of an auto parts

company is worth over 300 kindergarten teachers, in spite of the judgement of the so-called free market. At a time when over 20 percent of the children in this country and almost 60 percent of single mothers live in poverty, to give relatively well off Canadians, including tenured university professors like myself, a tax break, through the adoption of flat taxes, would not only be bad economic policy and perverse social policy, it would be immoral.