
The Flat Tax: An Idea Whose Time Has Come

by Jim Silye, MP

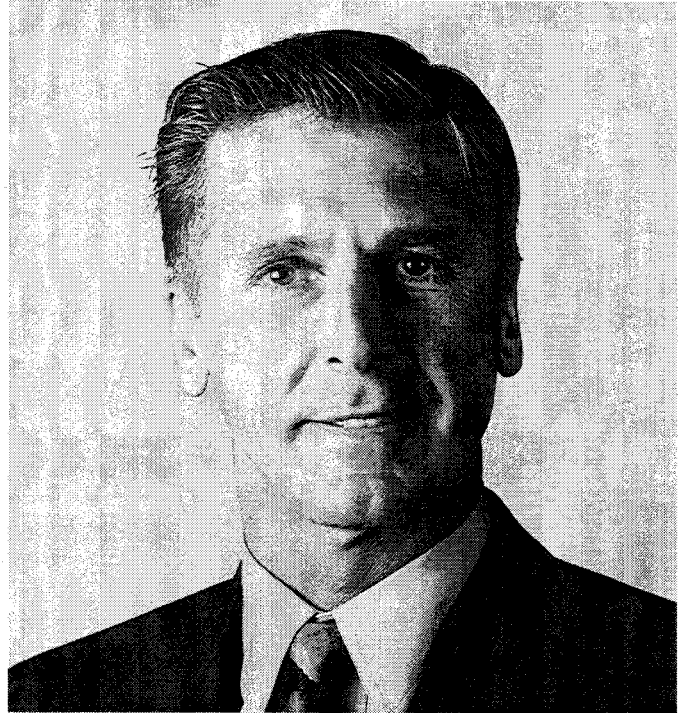
It has become an annual national nightmare. The end of April approaches. It is tax time, and Canadians spend untold hours of what could otherwise be enjoyable time working without pay for the Department of National Revenue.

It does not have to be this way. There is no reason for a country's revenue system to be as complex, convoluted and confusing as Canada's has become. Nor is there any reason for such high taxation levels. Indeed, for a very long time, it was not. The original 1917 *Income Tax Act* (a temporary wartime measure) was a little over 30 pages long, and as late as 1973 it was just over 200 pages. Today, it is over 2100 pages in length, and the current government has passed over 1200 pages of amendments, rulings and clarifications in its first two years in office. Why has this happened?

The fundamental answer to that question is simply that the purpose of a taxation system – *the generation of revenues to pay for legitimate government expenditures* – has been forgotten. Instead over the last 23 years, the tax system has grown into a direct tool for social and economic engineering, rewarding or punishing personal or investment behaviours in ways that suit the government and its favoured special interests. As it stands now, it is too easily manipulated by bureaucrats and politicians.

The bewildering array of deductions, credits, and other manipulations that comprise our tax system may have been well-intentioned in and of themselves, but the road to Hell is paved with good intentions. Tax experts themselves dread coming home from holidays to catch up on all the latest tax rulings from the Department of National Revenue.

My suggestion therefore, is to get rid of this obscene monstrosity. Not tinker with it. Not fiddle around the edges. Let us not adjust it here and there, let us get rid of it and replace it with a firm foundation that accomplishes



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its intended purpose. Finally let us do so in as simple, uncomplicated, and fair a manner as possible. In order to achieve this objective we probably have to revisit and redefine the purpose of taxation.

Why a Flat Tax?

The general shortcomings of the existing tax system have been discussed above, but the following major flaws are worth noting:

- The current system mis-allocates resources because it distorts private incentives: (a) through double-taxation of investment income it discriminates against savings and investment; (b) because the marginal tax rate is high, it discriminates against work and investment; and (c) the taxation of capital gains

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prevents wealth-holders from selling assets and reinvesting them in more profitable ventures.

- The tax system is too complex and the administrative and public compliance costs are too high (currently in the \$12 billion range). A simplified system of taxation clears the confusion and complications and would lend itself to more compliance at a lesser cost, especially with a lower rate and better understanding of who pays how much.
- The progressivity of rates of taxation, the taxation of capital gains caused by inflation, and the availability of opportunities for tax evasion make the personal and corporate tax systems unfair and lacking in transparency. It drives many Canadians into the underground economy and this industry is growing at an alarming rate due to government mismanagement.
- A Flat Tax should exempt low income earners and tax all other income equally so that the more you make, the more you pay without loopholes in order to strike the lowest possible single rate.

Not a New Idea

In recent years, a number of proposals for a flat tax system have been put forth, with the primary areas of variation among them centering around the definition of taxable income, the number of exemptions, and the selection of tax rate.

Probably the first significant proposal was that of Robert Hall and Alvin Rabushka in 1981. The United States House of Representatives Majority Leader Dick Arney is proposing a flat tax model for the US, and has received support of organisations such as the Heritage Foundation and Americans for Tax Reform. Liberal MP Dennis Mills has been advocating a single tax for Canada for some years. Currently, the Fraser Institute and economist Pierre Fortin have been recommending a flat tax. The Reform Party has a clearly defined policy stating that the Party will work toward a "simple, visible and flat system of taxation". In pursuit of that policy, my colleague Herb Grubel, M.P. from Capilano/Howe Sound and I have developed two alternative, comprehensive Flat Tax models for consideration. They differ in the treatment of investment, dividend income and the rate of depreciation, but both adhere to the fundamental concepts spelled out above.

What Is The Flat Tax?

Essentially, the flat tax derives its name from the fact that a single tax rate applies to all levels of taxable income (both personal and corporate), rather than the different marginal rates that apply at present. This is a major element of the simplicity of the system. It integrates personal and business income, taxing revenue only once at the same rate.

Simplicity is the most desired feature because it leads to fairness and visibility. A single rate, applicable to everyone, with a minimum or no exemptions and deductions, results in a tax system that anyone can understand without having to rely on professional guidance.

In keeping with the idea of simplicity, a flat tax system would have a very short, simple form. One page should be sufficient, although some supporting documentation would be needed when filing a return.

Simplicity provides people with the realization of fairness - if there are few or no complications, there are few or no ways for the clever to avoid paying their fair share. More people would voluntarily comply in paying taxes. The integration of personal and corporate taxes, both taxable at the same rate, eliminates the avoidance of tax by shifting income between business and individuals.

The reduction or elimination of exemptions and deductions with the exception of a personal deduction has two effects. One, as mentioned, is to introduce simplicity to the system. The second is to broaden the tax base, thus subjecting more sources of income to taxation. This in turn leads to a lower overall tax rate to generate the same amount of revenue. A low tax rate and a simple easy-to-understand system are the two main reasons why the vast majority of people are attracted to the concept of the flat tax.

What Does It Look Like?

The purest of flat tax systems would simply add up all sources of income (wages/salaries, investments, pensions, etc.), have no deductions of any kind, and simply take a percentage of the total as tax (say 10%). Unfortunately, there are problems with that idea. The most important is that it provides no cushion for the poorest among us - and a 10% tax off the top of a \$10,000 income leaves less on which to live than does a 10% tax on \$100,000. This is why every flat tax proposed to date includes a basic personal exemption, by which a certain minimum level of income is totally exempted from taxation. Setting that exemption level is one of the differences among the various proposals because it directly affects the tax rate.

In New Zealand a broad taxation base with low rates was translated into everyone being taxed from the first dollar of income earned. There is no personal, spousal or child care deductions. Instead, people in need or

receipt of benefit programs are compensated under direct spending programs.

Another difference is the number, type, and level of deductions to be allowed. These obviously have to correspond with the definition of income in order for the system to generate any meaningful revenue and yet be fair to all concerned.

For example in some models, only income from employment and business pensions is counted whereas interest and dividend income is tax exempt, while providing personal and spousal deductions and a child tax credit. Other models add up all sources of income (employment, investment, pensions, Unemployment Insurance benefits, etc.), but allow additional deductions (such as UI and CPP premiums and RRSP contributions). Drawing up the balance between these potentially conflicting requirements is probably the most difficult aspect of trying to devise a new tax system.

Of course, the flat tax system is not restricted to personal taxes. It can, and indeed must be applied to business as well, using the same basic principles so that people cannot avoid taxes by simply changing their identity from a business identity to a personal identity.

Part But Not All of the Answer

It would be nice to think that the elimination of the existing Income Tax system and its replacement with a simplified system of taxation (a Flat Tax) would solve all of our country's financial problems. But of course it will not.

Yes, a simplified system will relieve some of the distaste people currently feel for taxation. Reducing the job of filling out your tax return from one week to one hour, and knowing that everyone, rich and poor, individuals and corporations, are using exactly the same rules, will make the tax bite a little easier to take because of the inherent new fairness and efficiency gains not otherwise available.

But the real goal should be tax relief, whereby people see that tax bite getting smaller.

Tax reform must go hand in hand with real reductions in government spending. Decentralization, elimination of duplication among various levels of government, privatization of Crown Corporations, prioritization of spending from the absolutely necessary down to the totally unneeded (followed by the elimination of the latter), are the only ways government can reduce its need for the tax dollars that the revenue system brings in. Accountability in government spending is definitely a priority and sorely lacking in our present system.

We can simplify the tax system all we want, but people will still not willingly comply with even a simplified system if they perceive that their tax dollars are being wasted. Only when government cures itself of its addiction to spending other people's money irresponsibly will the combination of tax reform and tax relief come to full flower.