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Why a flat tax would be fairer and more efficient

A widespread myth holds that our personal income tax system with its progressive marginal rates[1] is meant to embody values of fairness, justice and "social solidarity." Supporters of this system argue that tax rates should rise with income as a way of creating a more even "level of sacrifice" among citizens. According to this line of argument, sacrifice is measurable and progressive tax rates produce a more equal result. An individual with a high income should sacrifice a larger share of it for the benefit of the state. Thus, the higher the income, the higher the tax rate should be.

This position seems to be based on the theory of declining marginal utility, which holds that the value to an individual of each additional dollar of income diminishes as income rises. However, even if we were to suppose that this theory applied in the area of taxation, the idea that people's respective levels of utility can be compared would have to be taken for granted for us to conclude that tax rates need to be progressive.

The progressive rates were entirely arbitrary at each reform and did not fit any objective measure of equal sacrifice.

It is simply not possible to compare the marginal utility to different individuals of a given sum of money since the economic concept of utility refers to each person's subjective satisfaction. There exists no objective scientific measure that can quantify satisfaction and provide for comparisons between individuals. Because of this, the idea that progressive tax rates help ensure equal sacrifice among citizens is purely a myth, devoid of scientific basis. Sacrifices made by different individuals cannot be measured or compared.

This impossibility explains the huge variety of systems across the world with progressive rates. In 1978, for example, the Quebec government imposed a 21-rate structure to achieve so-called equal sacrifice, while in 1986 seven rates were considered adequate for this purpose. In 1998, only three tax rates were apparently needed to achieve this same equality. On each occasion, these changes in the Quebec tax system were considered socially just and equitable. It is obvious that the progressive rates were entirely arbitrary at each reform and did not fit any objective measure of equal sacrifice.

Unequal pay for equal work

The arbitrary nature and iniquity of the current tax system can be illustrated through the example of a bus driver with a $25 gross hourly wage who works 22 hours a week and is offered 25 hours a week (see Table 1).

With $26,950 in annual income, the employee is near the upper limit of the initial $27,635 bracket taxable at a marginal rate of 16%. He thus receives a net pay of $21 for his last hour worked. If the bus driver decided to

[1] In Quebec, taking account only of the provincial income tax, marginal rates for the 2004 taxation year are 16% on the first $27,635 of taxable income, 20% on income between $27,636 and $55,280, and 24% on income exceeding $55,280. The marginal rate is what applies on each additional dollar of income.

This Economic Note was prepared by Maxime Bernier, vice-president of a large insurance company and author of the book *Pour un taux unique d'imposition* published in 2003 by Les Éditions Varia.

Table 1

The discriminatory effects of progressive tax rates

	22h/wk contract	25h/wk contract
Gross hourly rate	**$25**	**$25**
Number of weeks worked per year	49	49
Number of hours worked per year	1 078	1 225
Gross annual wage	$26 950	$30 625
Marginal tax rate (Quebec only)	16%	20%
Net hourly pay for the last hour worked	**$21**	**$20**
Pay gap between the two contracts		**– 4,8 %**

work additional hours, a 20% marginal rate would apply to him, and he would receive $20 in pay for each of these hours instead of $21, a reduction of nearly 5%. This results in unequal pay for equal work.

In other words, a progressive tax system leads to lower net income per hour worked for someone who decides to work more. With additional hours paying a lower net wage, workers have less incentive to exert greater productive effort or create additional wealth. This type of system deters individuals, including the less well off, from moving toward higher income levels because it imposes a tax burden that becomes heavier as a person does more work and climbs the professional ladder.

The current system is also justified by the argument that progressive marginal tax rates support "social solidarity" and ensure redistribution of wealth to the less fortunate. It is possible, however, to show solidarity in taxation without relying on progressive rates. Social solidarity can also be financed through a flat rate tax system in which, lest we forget, higher-income individuals would continue to pay more in taxes in absolute terms. Furthermore, wealth redistribution can also be achieved through budgetary expenses.

The economic effects of progressive rates

The heavier the tax burden on citizens, the more that wealth creation and economic growth are slowed. The relationship between tax pressures, prosperity and tax receipts has been the topic of numerous economic studies. The famous Laffer curve makes this clear, illustrating how government receipts can diminish as taxation rises beyond a certain level. Individuals refuse to create extra wealth, holding back on added investment or work; this results in a lower level of taxable income. The abusive weight of taxation deters officially registered employment, stimulates under-the-table work and broadens tax evasion, leading to further reductions in the tax base.[2]

The states with the highest marginal tax rates have lower rates of economic growth.

Economists John Mullen and Martin Williams have analyzed variations in the economic growth of U.S. states over two decades, with particular emphasis on the impact of marginal tax rates.[3] They found that the states with the highest marginal tax rates (highly progressive) have lower rates of economic growth. The results of this analysis were confirmed by the Federal Reserve Bank of Atlanta[4] whose study, covering a 30-year period and many U.S. states, also observed a significant negative relationship between tax pressures and economic growth.

Levels of tax pressure and government borrowing, where expenses are financed by public deficits, are linked directly to the size of government. A study

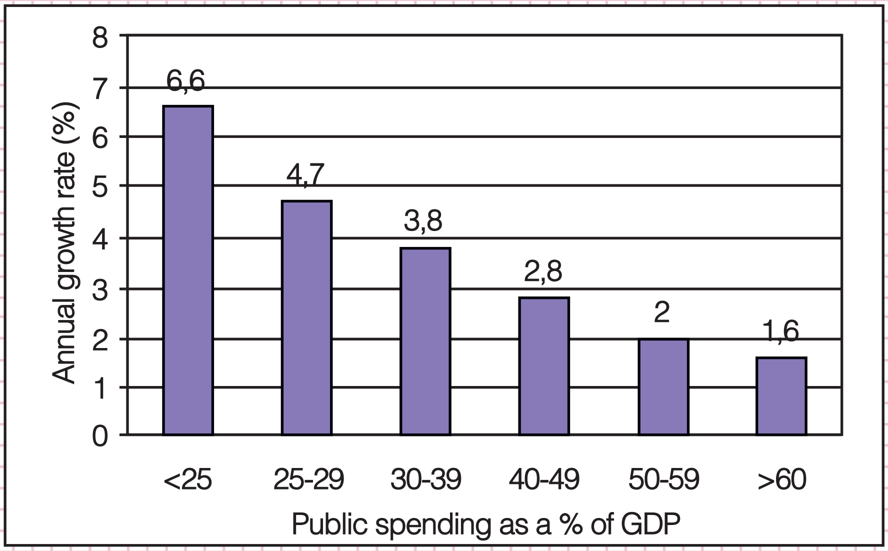
[2] On this topic, see Norma Kozhaya, *Les bienfaits économiques d'une réduction de l'impôt sur le revenu,* Montreal Economic Institute, March 2004.

[3] John Mullen and Martin Williams, "Marginal Tax Rates and State Economic Growth," *Regional Science and Urban Economics,* 24 (6), 1994, pp. 687-705.

[4] Zsolt Becsi, "Do State and Local Taxes Affect Relative State Growth?", *Economic Review,* Federal Reserve Bank of Atlanta, 81 (2), 1996, pp.18-36.

Graph 1

Government size and annual growth in real GDP (OCDE countries, 1960-1996)



Source: Gwartney, Lawson et Holcombe (1998), p. 9.

produced for the United States Congress[5] analyzed the influence of government size on economic growth. The research, covering 23 OECD countries over a period of 36 years, found that a rise of 10 percentage points in government spending as a share of gross domestic product (GDP) causes a permanent reduction of about one point in annual economic growth. Graph 1 illustrates this relationship between the size of government and economic growth.

Finally, a U.S. study from the National Bureau of Economic Research examined the effect of taxes on the income of individual entrepreneurs and its impact on their investment decisions. The authors estimate that a 5% rise in marginal tax rates reduces the proportion of entrepreneurs making new investments by 10.4% and cuts investment spending by 9.9%. High progressive income tax rates thus deter entrepreneurs from engaging in greater capital spending.

Examples of flat tax systems

Six U.S. states,[7] as well as Hong Kong and Alberta, already have single-rate income taxes. The most recent wave of reform on this path comes, however, from central and eastern Europe. Estonia adopted a 26% flat tax in 1993, Latvia a 25% rate in 1995, and Lithuania a 33% rate in 1996. Russia followed on January 1, 2001, with a 13% single rate that replaced a tax system with a 30% marginal rate applying to any income above US$5,000. Serbia and Ukraine took a similar course in 2003 and 2004. The latest and most ambitious reform took effect in Slovakia on January 1, 2004, with value added tax, corporate income tax and personal income tax set at a single rate of 19%.

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The results of these reforms concur with the teachings of economics, generating higher growth and thus higher tax receipts for governments. In Estonia, after general tax levels were reduced and a single rate introduced, lower tax receipts might have been expected. The contrary occurred, and receipts rose substantially. While boosting economic growth, tax reform also helped transform Estonia from a country of workers to a country of entrepreneurs: the number of businesses went from 2,000 in 1992 to 70,000 in 1994.[8]

[5] James Gwartney, Robert Lawson and Randall Holcombe, *The Size and Functions of Government and Economic Growth,* Joint Economic Committee Study, United States Congress, 1998.

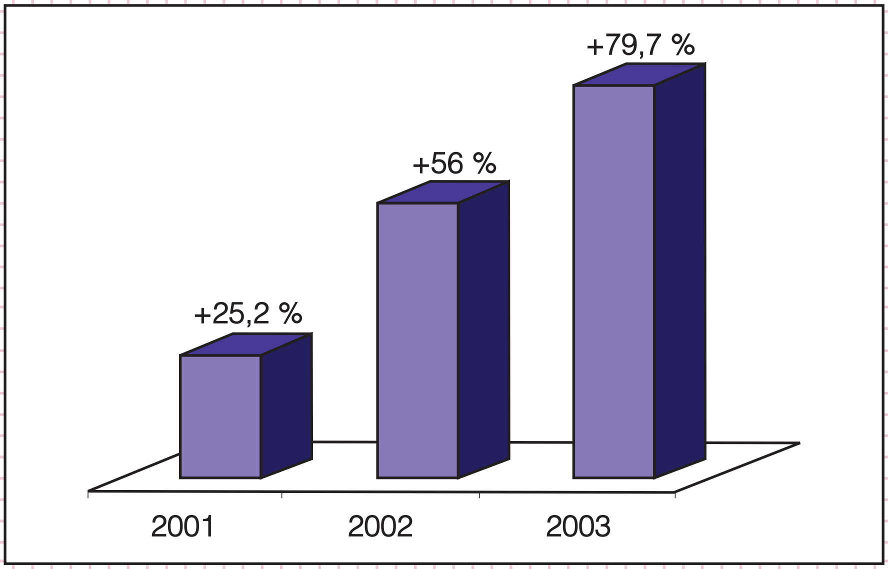
[6] See Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey S. Rosen, *Entrepreneurs, Income Taxes and Investment,* Working Paper 6374, Cambridge, MA, National Bureau of Economic Research, 1998.

[7] According to the Federation of Tax Administrators, these states are, as of January 1, 2004: Colorado, 4.63%; Illinois, 3%; Indiana, 3.4 %; Massachusetts, 5.3%; Michigan, 4.0%; and Pennsylvania, 3.07%.

[8] Mart Laar, *Little Country That Could,* CRCE, London, 2002, p. 276.

Graph 2

Cumulative inflation-adjusted growth in Russian income tax receipts (2000 = 0)



Source: Alvin Rabushka (2004).

Russia saw its income tax receipts rise by 25.2 % in 2001 when adjusted for inflation. The trend continued in 2002 and 2003, with receipts up 24.6% and 15.2% respectively.[9] Cumulative growth in receipts was nearly 80% in real terms in 2003 compared to 2000 (see Graph 2).

Conclusion

A flat rate income tax system respects the principle of equality of citizens before the law. The rule is the same for all: one rate for all citizens. The tax is set at a rate that does not vary based on wage levels, just as the property tax rate is uniform for all residents of a municipality and does not change according to the value of a building.

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A flat tax is not only justified from the standpoint of fairness but also avoids penalizing productive effort and wealth creation, as a progressive system does. There is no shortage of international examples: for once, the former communist countries are able to give the western world and Canada a lesson in public policies that are more compatible with a market economy than current tax systems with progressive rates.

[9] Alvin Rabushka, *The Flat Tax at Work in Russia: Year Three,* Hoover Institution, April 26, 2004.

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