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Five Single Rate Tax Thoughts

By David Seymour



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Executive Summary

- The flat tax has risen from academic obscurity to the policy of choice for 25 nations over the last 15 years. Of the nations that adopted the flat tax, none has abandoned it despite spirited political challenges or changes of government. These countries have often been able to reduce their rates over time, reflecting the strong revenue-gathering function of the flat tax.
- While multi-rate tax structures are intended to collect proportionately more revenue from higher income earners, it is important to recognize that income tax burdens are partially passed on to the consumers of the goods and services which the income earner produces. Depending on the relative supply and demand elasticity of high-income earners who sell their labour and the low-income consumers who buy their products, the ironic result that progressive tax structures hit the poor hardest is theoretically possible and may well be a practical reality.
- While multi-rate taxation systems are partially intended to reduce inequalities caused by accidents of fortune or misfortune in life, it is worth noting that one of the biggest determinants of income is actually age. The average 45 to 54 year old in Saskatchewan earns \$46,800, which is almost two-and-a-half times the \$18,800 that the average 20 to 24 year old earns. Much of the income inequality that progressive taxation is designed to alleviate is between people at different life stages rather than between people with different life fortunes.
- While proponents of multi-rate taxation structures often claim it is more moral to take “from each according to his abilities [and give] to each according to his needs,” there is an alternative view: Because high-income earners account for a very small number of voters, progressive tax structures are in place simply as the result of a cynical political calculus. It is up to voters to decide whether singling people out for extra taxation because politicians can fit their sense of morality.
- Income is not wealth, so incremental income taxes are a poor mechanism for targeting wealth. This realization should be obvious but is often overlooked in the rhetoric of tax policy, for example “taxing the rich.” Clarifying the language to talk only about taxing income would not only be a more precise way to discuss tax structures, it would also sanitize the discussion of unhelpful class warfare type rhetoric.

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Introduction

The income tax structure has been an area of relatively little public policy debate for most of the previous century. It has been widely accepted that having a hierarchy of tax rates wherein higher levels of personal income result in higher percentage tax rates is a just and economically efficient way to raise revenue. For example, in Saskatchewan there is an 11 per cent tax on the first \$39,135 of income (excluding the basic personal exemption of, \$13,269), 13 per cent on the next \$72,679 and 15 per cent on all income above \$111,814.

However, this wisdom has been challenged theoretically and in practice over the past two decades. In 1983, Stanford University economists Alvin Rabushka and Robert Hall made the case for a single rate of personal income tax with no exemptions other than for investment, so the tax would effectively be a consumption tax levied on income. This system would make it simpler and cheaper for revenue agencies to collect taxes and for taxpayers to comply with the regulations. It would also create fewer distortions in the economy than systems involving multiple rates, numerous exemptions and special treatments do.

At this time, only a minuscule number of small jurisdictions worldwide had systems that approached the pure flat tax model advocated by Rabushka and Hall, and to date, no jurisdiction has such a system in its pure form.

However, there has been a global revolution in taxation policy over the past decade, and at least 25 jurisdictions now have tax regimes that approach the flat tax model. They have adopted or significantly moved toward adopting the following measures:

- A single, flat rate of tax on income above some threshold;
- The elimination of special treatment in the tax code for certain individuals or industries;
- A neutral treatment of savings and investment.¹

The first provision is different from the second and third in that the single rate structure is an initiative that is independent of simplifying other aspects of the tax code. Simplifying the tax code certainly reduces compliance and enforcement costs and reduces the effects of economic distortion where different industries, different activities and different individual behaviours are punished or rewarded according to politically set tax treatments. The subject of this paper is the single rate aspect of the flat tax, and it reviews some of the arguments in favour of having one rate for all taxable personal income.

In Canada, Alberta has had a provincial tax regime with a single rate of tax on personal income since 2001, when an initial rate of 11 per cent was introduced (now 10 per cent). In 2008, New Brunswick's Department of Finance released a discussion paper that proposed that the province reform its tax structure to a single rate of 10 per cent or two tax rates of 9 per cent and 12 per cent.² Meanwhile, in Saskatchewan, the government advisory board Enterprise Saskatchewan recommended that Saskatchewan also reform its tax system to a single rate of 10 per cent.

The arguments for a multi-rate tax structure that applies higher rates of taxation to higher levels of taxable income are well rehearsed and obvious.

At their most basic, these arguments state that because taxpayers who earn higher incomes can afford to pay taxes over and above what they would pay at the base rate, they should.

However, this paper examines alternative thoughts on the multi-rate structure from two broad angles. First, how effective is it at making those with greater means contribute to public revenue, and second, is that really a desirable goal?

It begins with a survey of the flat tax's recent popularity around the world, as

jurisdiction after jurisdiction has adopted it. It looks at the true economic effect of imposing a tax on an employee's income as well as the effect on the consumers who ultimately consume the products the employee produces. It considers the identities of different taxpayers and finds that income-based taxation is as much a function of age as it is a function of lifelong earnings. Finally, it considers the moral implications of having a tax structure that allows the majority to impose higher taxes on a minority.

The Growing Popularity of the Single-Rate Tax

The single rate tax was a policy anomaly for most of the 20th century; however, it has been adopted by over 25 jurisdictions in the past two decades. In their book *Global Tax Revolution*, Dan Mitchell and Chris Edwards describe the emergence of a "flat tax club" thusly:

... [S]ome experts and international organisations have argued that flat taxes are not practical in the real world. Hong Kong has had a flat tax since 1947, but that was considered to be a special case because of that jurisdiction's colonial status. There have been flat tax systems in Jersey and Gurnsey, but those British territories are small and little known. And Jamaica has had a flat tax since 1986, but it has been overlooked perhaps because it had a high rate initially and Jamaica is a developing nation.

The Baltic nations of Estonia, Latvia, and Lithuania adopted flat tax systems in the 1990s, but critics downplayed these reforms because those countries were relatively small. This decade, Russia

and other large European nations began adopting flat taxes, and commentators started to concede that flat taxes made sense, at least for transition economies.

However, some critics continued to dismiss the spread of flat taxes as if it were a temporary fad. An International Monetary Fund study in 2006 stated boldly, "Looking forward, the question is not so much whether more countries will adopt a flat tax, as whether those that have will move away from it." Yet a dozen more nations have joined the flat tax club since the IMF assessment, including the first mature and high-income economy, Iceland.³

There are 25 flat tax jurisdictions in the world. Alberta would qualify for this list if it were a sovereign nation, as would several U.S. states. No jurisdiction that has adopted a flat tax has abandoned it. Given the number of jurisdictions with flat taxes and the nature of politics, it is almost inevitable that a political situation will eventually arise that will reverse a jurisdiction's adoption of the flat tax.



Flat Tax Adoption Around the World⁴

Jurisdiction	Year Individual Flat Rate Adopted	Initial Rate	Current Rate
Jersey	1940		20%
Hong Kong	1947		15%
Guernsey	1960		20%
Jamaica	1986		25%
Estonia	1994	26%	21%
Lithuania	1994	33%	24%
Latvia	1995	25%	15%
Russia	2001	13%	13%
Slovakia	2004	19%	19%
Ukraine	2004	13%	15%
Iraq	2004		15%
Romania	2005	16%	16%
Georgia	2005	12%	12%
Kyrgyzstan	2006		10%
Pridnestrovie	2006		10%
Trinidad	2006		25%
Iceland	2007	36%	36%
Mongolia	2007		10%
Macedonia	2007	12%	10%
Montenegro	2007	15%	15%
Albania	2007	10%	10%
Mauritius	2007	15%	15%
Czech Republic	2008	15%	15%
Bulgaria	2008	10%	10%

However, the fact that this has not happened yet suggests that voters in flat tax jurisdictions are generally happy with the system.⁵

It is also worth noting that with the exception of the Ukraine, where the original flat tax legislation called for a future rate

increase, flat tax jurisdictions have generally lowered their tax rates over time. This suggests that far from putting pressure on government revenue, the flat tax provides sufficient revenue to meet public-spending expectations, even while reducing tax rates.

It would be wrong to claim that these lower rates are necessarily the result of the flat tax alone. Most of the countries that have adopted the flat tax have done so in concert with numerous other policy reforms that have allowed their economies to grow rapidly after decades of poor public policy. However, it is reasonable to say that, at the very least, the flat tax has not prevented governments from gathering substantial revenue.

Indeed, in the case of Russia, the top tax rate was reduced by more than half from 30 per cent to 13 per cent in 2001. Since then, revenue has increased by more than two-and-a-half times, while the nominal GDP has less than doubled. In other words, Russia is a clear example of more taxes

being collected despite a much lower top tax rate.⁶

That a wave of countries, mainly in the former Soviet Union and Eastern and Central Europe, has adopted the flat tax in recent years does not constitute a valid argument that other jurisdictions should do the same. The history of public policy is full of bad ideas that nonetheless gained popularity. However, this widespread adoption of the flat tax combined with its universal retention amongst its adopters and the fact that many flat tax nations are able to lower their tax rates after introducing the single rate tax shows, at the very least, that single rate taxes are workable.

Taxes Do Not Fall Solely on Employees

One of the central premises behind the multi-rate tax structure is that it taxes people according to their ability to pay. People with higher incomes, the argument runs, can afford to pay more, so they should be charged higher rates on their higher incomes. However, there is a technical problem with this argument in that the costs of taxation do not fall exclusively on employees; they are shared between the employee and the consumers of what the employee produces. One scholar quotes Adam Smith:

A direct tax upon the wages of labour, therefore, though the labourer might perhaps pay it out of his hand, could not properly be said to be even advanced by him; at least if the demand for labour and the average price of provisions remained the same after the tax as before it. In all such cases not only the tax, but some-

thing more than the tax, would in reality be advanced by the person who immediately employed him. The final payment would in different cases fall upon different persons. The rise which such a tax might occasion in the wages of manufacturing labour would be advanced by the master manufacturer, who would both be entitled and obliged to charge it, with a profit, upon the price of his goods. The final payment of this rise of wages, therefore, together with the additional profit of the master manufacturer, would fall upon the consumer.⁷

Smith is half-right about the incidence of taxation falling on consumers rather than on producers. He is right to say that the person out of whose wages the tax is paid does not pay the entire cost of the tax. As a corollary, advocates of higher tax rates on higher incomes should realize that others are paying some of the tax burden.

In practice, this burden is shared between the employee and the end consumer in a proportion determined by their relative supply and demand elasticity.⁸

To understand where the true tax burden falls, it is necessary to understand the concepts of consumer surplus and producer surplus.

Consumer and Producer Surplus

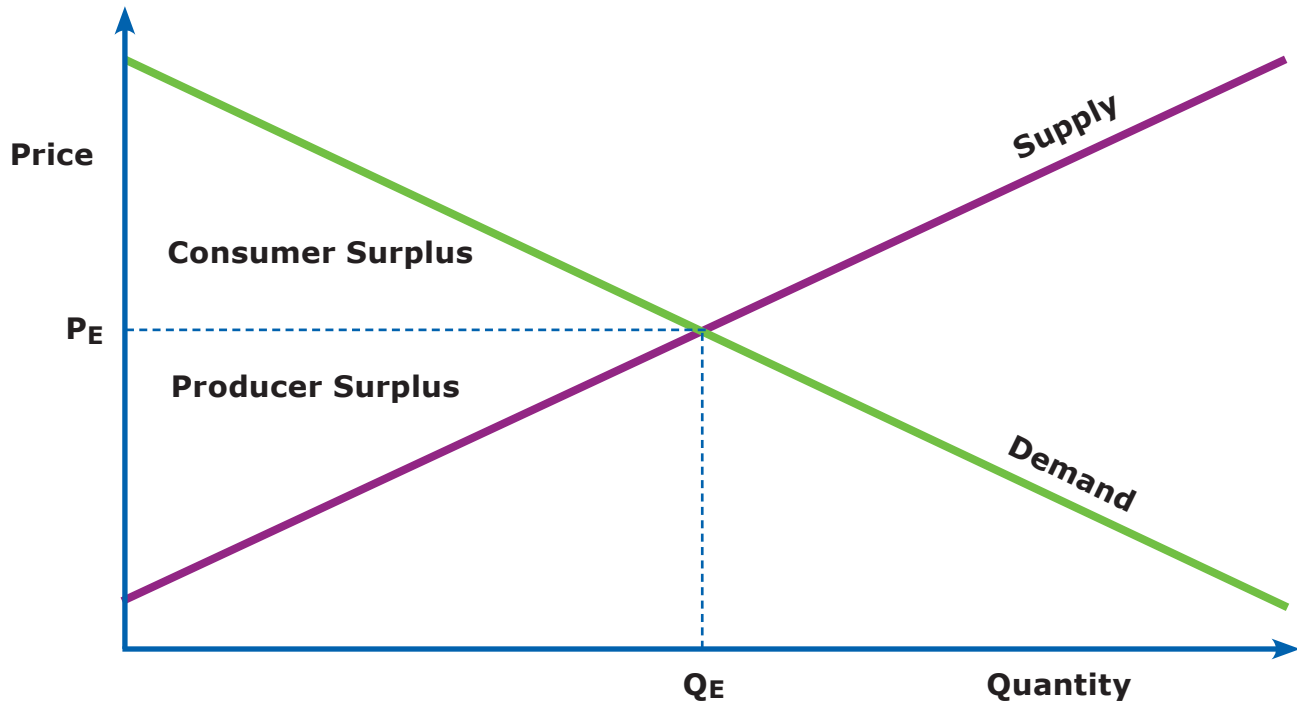


Figure 1.

Figure 1 shows the basic economic expression of a market. Supply is a schedule of quantities of some product that a producer (in this case an employee as a producer of labour) will provide at different prices. Naturally, producers manufacture more when prices are higher. Demand is the schedule of quantities that consumers (in this case employers are consumers of labour who in turn sell their goods and services to everyday consumers who are the ultimate consumers in this arrangement). Naturally, consumers demand greater quantities when prices are lower.

$P_E Q_E$ is the point where producers and consumers “agree” on a price and a quantity to be provided. However, if the quantity was any lower, producers would be prepared to charge less and consumers would be prepared to pay more. The effect is that both sides of the deal get most of what they produce and/or consume at a better price than they would be prepared to accept at that quantity.

These quantities are the producer surplus and the consumer surplus. They represent the mutual benefits of a transaction. The imposition of a tax reduces both the consumer surplus and the producer surplus.

The Effects of Taxation on Producer and Consumer Surpluses

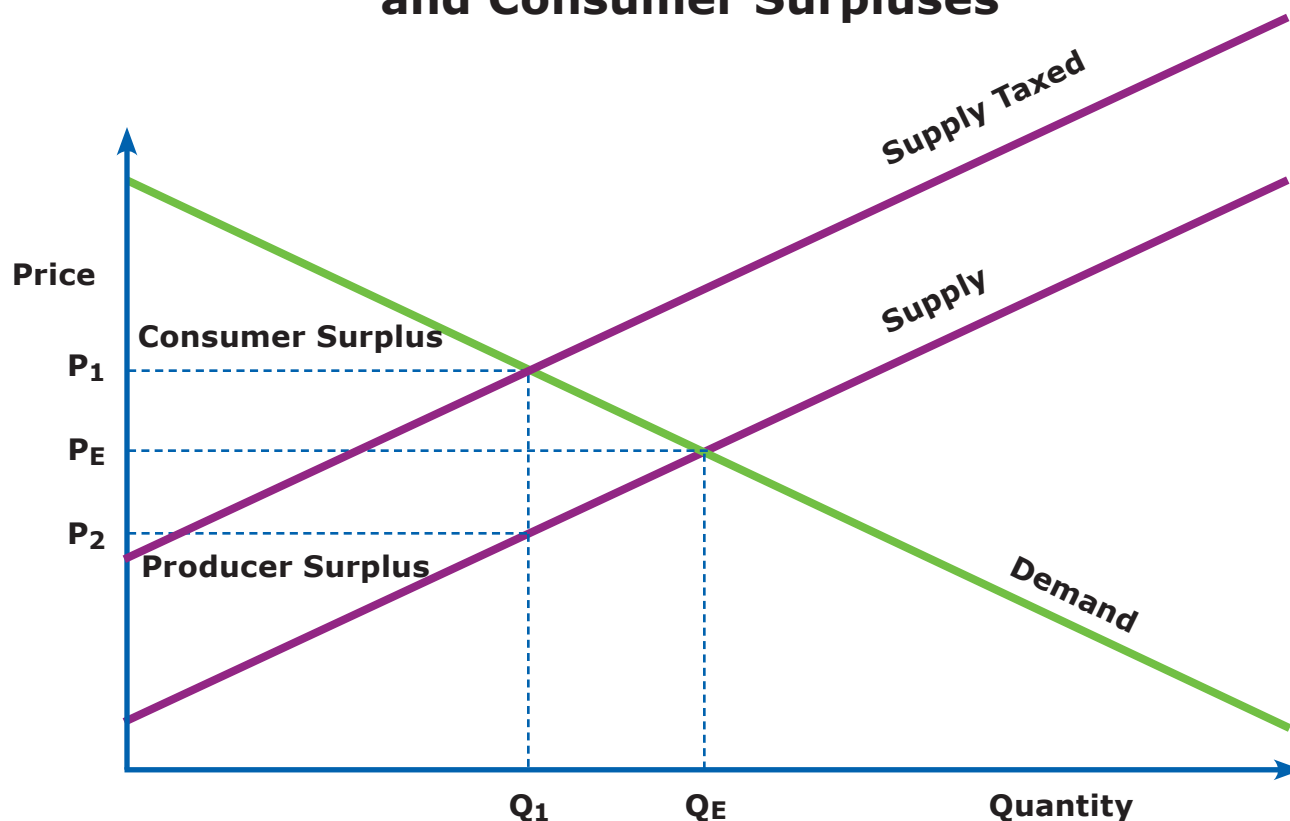


Figure 2.

The imposition of a tax on income means that employers, and ultimately the everyday consumers who buy their product, face a supply curve (Supply Taxed) that provides less product at a higher price. The taxes collected by government are represented by the rectangle bounded by P_1 , P_2 and Q_1 . The effect on employees as producers of labour is that they now collect a lower price, P_2 , than before the tax was imposed. This represents the effective tax burden carried by the employee. However, because consumers of the same labour now pay the higher price, P_1 , instead of P_E , the employer, and ultimately the everyday consumer of the firm's goods or services, pay some of the tax burden.

This dynamic has consequences for the effects of placing higher tax rates on higher incomes. While employees hit with higher marginal tax rates certainly cede some of their income to the tax, the effect on consumers is similar to a flat consumption tax on everything they buy.⁹

How much of the tax burden is borne by the consumer and how much by the employee depends upon the elasticity of their respective demand and supply schedules. Elasticity is the ratio between the percentage change in quantity demanded (by consumers) or supplied (by producers) and any percentage change in price, including prices brought about by taxes.

The Effects of Taxation with Elastic Demand (L) and Elastic Supply (R)

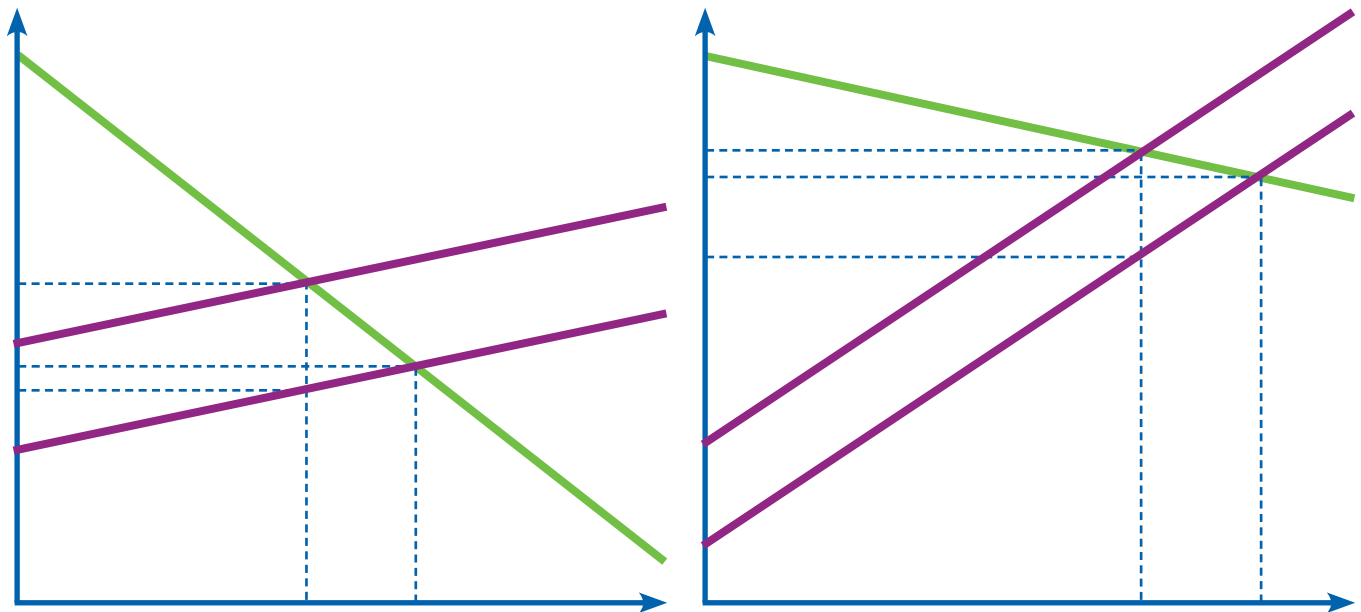


Figure 3.

Figure 3 shows the effect of taxes on producers and consumers depending on whether their respective supply and demand is more elastic than that of the other. The right-hand figure shows a scenario where the demand curve is more elastic than the supply curve. Consumers will adjust the quantity they demand in response to price changes more than producers will change the quantity they are prepared to supply. The result is that producers shoulder a larger part of the tax burden after a tax is introduced because it is more important to them that the deal go ahead regardless of price; hence, the steeper supply curve, which shows that the quantity they demand is less sensitive to price. In the reverse situation on the left, the consumer pays the majority of the tax burden.

Higher tax rates on higher incomes are intended to collect more from those who are most able to pay. However, the observations in this section bring about an ironic possibility: The effects of multi-rate income taxes are actually regressive.

For regressivity to happen, the supply of labour from employees to whom higher marginal tax rates apply would have to be more elastic than the demand for their goods and services from low-income consumers whom progressive tax structures are supposed to help.

This scenario is not difficult to imagine. Advocates of progressive tax structures often point out that somebody earning \$100,000 values that last dollar less than does somebody earning \$20,000 as a justification for taking more tax from the former. However this observation also implies that high income earners also have more discretion in changing their behavior (e.g. by working less) in response to price changes created by taxes. For example, a high-income supermarket executive supplies services to all consumers of groceries including those on low incomes who have little flexibility in their purchasing. The supermarket executive has a relatively elastic supply curve; he, or she, can afford to reduce the quantity of labour

produced in response to tax changes more easily than a low-income consumer can afford to reduce the quantity of the essentials he or she can afford.

In practice, the actual elasticity is difficult to calculate for either party. However, this section serves as a warning to advocates of multi-rate tax structures to be careful what they wish for. At the very least, the targeting of marginal tax rates is less

effective than it seems because people other than the actual income earners pay some of the economic burden from higher rates on higher incomes. At worst, there is the theoretical possibility, if not the reality, that the real economic effect of imposing higher tax rates on higher incomes is, ironically enough, the punishment of low-income earners.

Soak the Rich—or the Middle Aged?

The obvious feature of progressive tax structures is that they target high-income earners. The easy assumption is that such earners are somehow lucky or advantaged, so they deserve to pay a higher proportion of their income into public revenue for the

benefit of those without such advantages. However, one feature of high-income earners that is overlooked is their age. As workers gain experience they are generally paid more and therefore become targets of a progressive income structure.

Average Market Income vs Age in Saskatchewan (2007)¹⁰

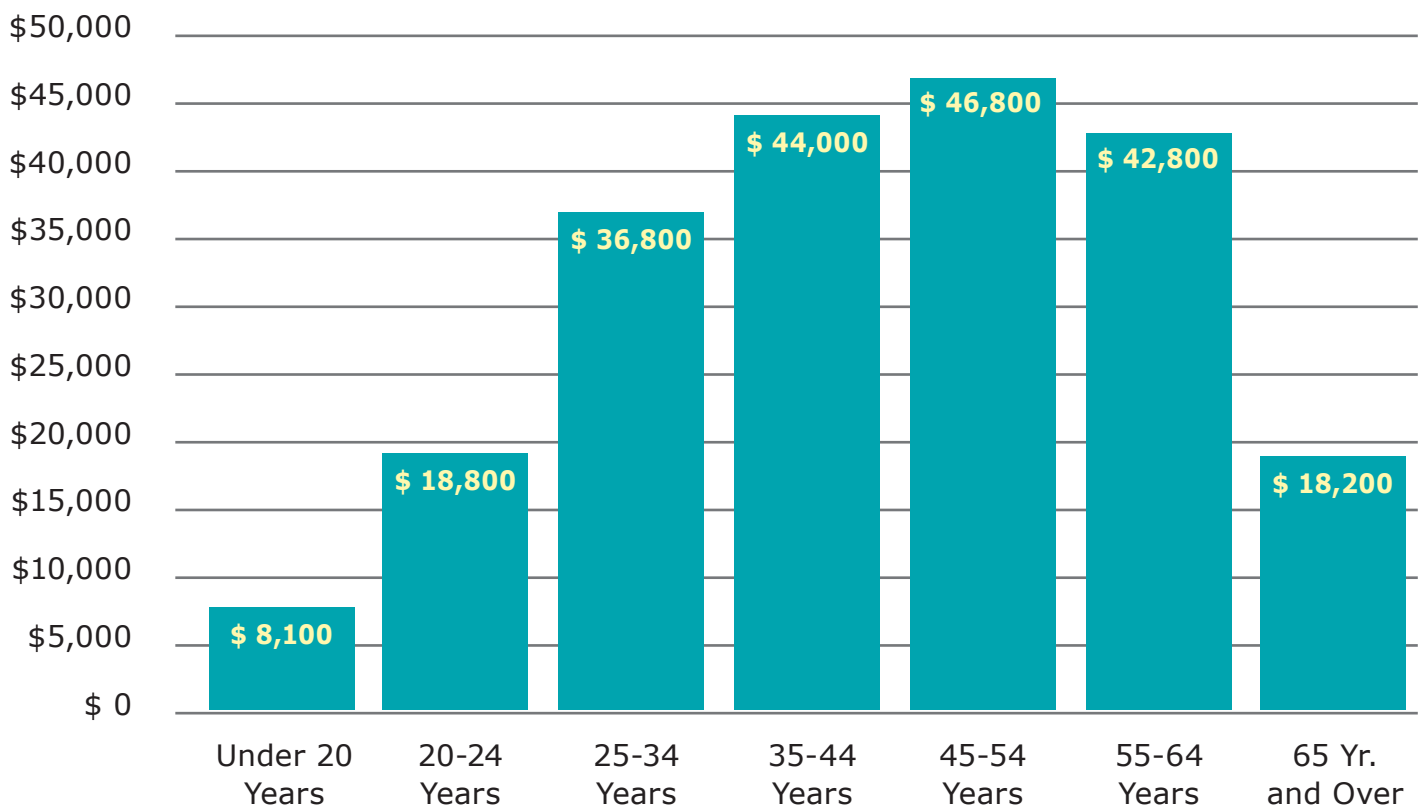


Figure 4.

Figure 4 shows that workers are much more likely to pay the secondary rate of 13 per cent tax on income over \$40,113 in their 40s and 50s than in their early career or during retirement. Of course, these average figures hide significant income variations within age brackets, and age does not entirely explain income variations, but it is a powerful factor.

To the extent that income is a function of age, multi-rate tax structures do not alleviate inequalities between people; rather, they tax the same people differently at different times in their lives. Considering that people in the higher income age groups are more likely to have dependents, the wealth equalizing effects of multi-rate systems are duller still.

Progressive Taxation and the Tyranny of the Majority

The moral case for progressive taxation is best captured by the Karl Marx quote, “from each according to his ability, to each according to his needs.” However, another perspective on progressive taxation is that it is levied simply because it is politically possible to do so.

A single rate tax already taxes citizens in proportion to their income; the real difference between a single rate system and a multi-rate system is that the multi-rate system targets a small number of taxpayers who must pay additional taxes.

- In a pure flat tax system with a 10 per cent flat rate, somebody earning \$10,000 pays \$1,000; somebody earning \$20,000 pays \$2,000; and somebody earning \$200,000 pays \$20,000.
- However, because all flat taxes that have been introduced so far (and the one proposed for Saskatchewan) have an exemption threshold below which no tax is payable, they are also progressive. Assuming a \$10,000 basic personal exemption in the example above, the three taxpayers pay zero, \$1,000 and \$19,000 or 0 per cent, 5 per cent and 9.5 per cent average rates, respectively.

Thus, multi-rate tax structures are not

I have no respect for the passion for equality, which seems to me merely idealizing envy...

- Oliver Wendell Holmes, Jr.

about higher income earners paying more than lower income earners; they do that under a single rate system anyway. Rather, it is about applying additional, punishing rates over and above proportionality to a minority of taxpayers.

The taxpayers to whom higher tax rates are applied under a multi-rate system are invariably a minority of voters. A less eloquent parallel to Marx’s quote would be “we’ll tax you because we can.” Lauchlan Chipman quotes a more eloquent Friedrich Hayek:

In the last resort the problem of progressive taxation is, of course, an ethical problem, and in a democracy the real problem is whether the support that the principle now receives would continue if the people fully understood how it operates That a majority should be free to impose a discriminatory tax burden on a minority; that, in consequence, equal-

services should be remunerated differently; and that for a whole class, merely because its incomes are not in line with the rest, the normal incentives should be practically made ineffective—all these are principles which cannot be defended on grounds of justice. If, in addition, we consider the waste of energy and effort which progressive taxation in so many ways leads to, it should not be impossible to convince reasonable people of its undesirability. Yet experience in this field shows how rapidly habit blunts the sense of justice and even elevates into a principle what in fact has no better basis than envy.¹¹

Chipman also argues that political inertia is a blockade against the flat tax:

If a flat income tax is such a good idea, then why are not more countries introducing one? The answers would appear to lie in the perceived political difficulties involved in making the transition. It is therefore interesting to note that, in the revolutionary situation that followed the collapse of the Soviet Union, a number of the former constituent republics opted for a flat rate of personal income tax.¹²

Mitchell and Edwards write, “The nations that emerged from communism’s collapse are leaders in the flat tax revolution. People in those countries endured decades of socialist propaganda. Now that they are free, they apparently have little sympathy for tax systems based on resentment and class warfare.”¹³

As noted earlier, proponents of progressive taxation often point out that higher income earners do not “need” their last dollar as much as those on lower incomes do. This may well be their view, but whether or not it is right for the majority of voters to impose that value system on higher income earners through different tax rates is a separate question.

Morality is ultimately a personal choice. Debates between ethical absolutists, who believe that certain moral principles are sacrosanct regardless of their consequences, and utilitarians, who believe the rules of society should aim for “the greatest good for the greatest number,” are as old as philosophy itself and cannot be settled here or perhaps anywhere.

Nevertheless, the moral implications of progressive taxation versus single rate taxation should be considered for what they are, and it is up to voters to decide whether a system that takes “extra” money from a minority simply because it can, truly reflects their own moral preferences. They should also consider whether or not they truly want a society where the majority uses the tax system to prey on the minority.

Taxing the Rich?

Much of the dialogue around income taxes and multi-rate structures in particular misses a very simple point that should not need restating: Income taxes are levied on income. However, commentators regularly label tax reductions on high income as “tax cuts for the rich” as if it were wealth that is targeted by multi-rate tax structures.

The dictionary definition of “rich” is “having abundant possessions and especially material wealth.”¹⁴ As logic and several anecdotes below show, there is no necessary connection between income declared for taxation and being rich in this widely understood sense.

Changing the language of the dialogue around multi-rate taxes would not be merely a pedantic exercise. Although accurate language is always advantageous, this change would be particularly clarifying in the multi-rate tax debate.

It would eliminate a lot of the resentful class warfare rhetoric around tax rates by removing the idea that the taxes are targeting a class of people rather than earnings in a particular year.

It would also acknowledge that much of the world's individual wealth does not pass through income tax systems. A famous example is investor Warren Buffet's declaration that he pays less tax than his secretary does despite earning \$46-million to her \$60,000.¹⁵ Since Russia dropped its highest tax rate from 30 per cent to 13 per cent in 2001, it has provided more evidence that not all income is necessarily declared for income tax purposes. Despite this large reduction in the tax rate, its revenue is two-and-a-half times greater, implying that over five times as many rubles passed through the tax system in 2007 as in 2000.

Yet, nominal GDP less than doubled during this period.

The Buffet and Russian examples point to the difficulties involved with talking about taxing the "rich." With the assumption that tax-declared income is equal to wealth, it makes sense to ramp up tax rates on higher incomes. However, as Buffet's anecdote and the Russian experience show, tax-declared income is not interchangeable with wealth, and therefore higher tax rates are a blunt instrument for the goal of creating equality of wealth.

With the distinction between wealth and income better understood, the debate over multi-rate taxation could become more focused on what income taxes can and cannot achieve.

Conclusion

The discussion over the single rate tax could benefit from a number of clarifications. The idea that higher rates of tax on higher incomes are economically efficient and just because they ensure those with a greater ability to pay is almost certainly true to some extent. Nevertheless, the five quick thoughts in this paper show that extent to be much lesser than might be

believed at first. Taken together with the moral consideration of whether it is right to target a minority of taxpayers with higher rates and the broadly successful move toward single rate taxes in a rapidly increasing number of jurisdictions around the world, it is perhaps time for Saskatchewan to consider moving to a single rate tax system.

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http://www.fcpp.org/main/publication_detail.php?PubID=2152



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