Conversations from the FRONTIER CENTRE FOR PUBLIC POLICY

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WITH Daniel Mitchell, Cato Institute Senior Fellow and Global Tax Expert

Daniel J. Mitchell is a top expert on tax reform and supply-side tax policy. Mitchell is a strong advocate of a flat tax and international tax competition. Prior to joining Cato, Mitchell was a senior fellow with The Heritage Foundation, and an economist for Senator Bob Packwood and the Senate Finance Committee. He also served on the 1988 Bush/Quayle transition team and was Director of Tax and Budget Policy for Citizens for a Sound Economy. His articles can be found in such publications as the *Wall Street Journal*, *New York Times*, *Investor's Business Daily*, and *Washington Times*. He is a frequent guest on radio and television and a popular speaker on the lecture circuit. Mitchell holds bachelor's and master's degrees in economics from the University of Georgia and a Ph.D. in economics from George Mason University. Dr. Mitchell was interviewed by the Frontier Centre at the Mont Pelerin Society meeting in Tokyo September 2008.

Frontier Centre: You are a researcher at the CATO Institute, a think tank in Washington, D.C. and you focus on the issue of taxation right around the world and in particular promoting competition between tax jurisdictions and also the flat tax. Could you tell us, just for people who might not be familiar with flat tax, what is a flat tax and what makes it different to other tax systems?

Dan Mitchell: There are really several key features of a flat tax. The most obvious one that people tend to know about is that it has one rate, usually with an exemption based on family size but once your income climbs above a certain level then you play flat 10%, 15%, 20% whatever the rate happens to be. And if you look around the world, the rates do vary from 10% in several countries to 36% in Iceland (which isn't exactly my idea of the ideal flat tax rate) but it's progress from where they had come from. It's not just a single tax rate. Another key provision or element of a flat tax is that you tax income only one time. So there is no death tax, no wealth tax, no double taxation on dividends, interest or capital gains. It's what economists would call a consumption based tax which is just a fancy way of saying a system that taxes income only one time. By having a system that taxes income only one time you get rid of the bias against savings and investment, which means you have more capital formation in your economy which of course is the key to rising wages and higher living standards. Then of course the final provision of a flat tax is that you get rid of all the special preferences, exemptions, deductions and credits and other special interest loopholes that tend to be like barnacles on a ship of modern Western tax systems. So all the special interest provisions are gone, you literally can shrink your tax codes and you can fill out your tax returns on a postcard whether you are the biggest business in the country or whether you are the smallest household in the country.

FC: I guess one of the big concerns that people might have, especially in Canada, there's a belief that having higher tax rates on higher income means that the people that can pay more, pay more and it makes us a more equal society. Would that be lost under a flat tax?

DM: I think the old class warfare notion of punishing more successful people with higher tax rates is based on a mistaken view of equality. Equality should mean that the rules apply the same to everyone. So if Bill Gates makes a million times more than I make, he should pay a million more times more in tax. If I make twice as much as my neighbour, I should pay twice as much in tax. That's what equality is and actually etched above the Supreme Court in the U.S. in the stone is the statement "Equal Justice Under Law." Under the current tax system with discriminatory tax rates, special loopholes, national penalties we clearly are not satisfying the principle of "equal treatment under law." If you move to a flat tax, you are treating everyone equally and I would point out that for the class warfare people who want to punish the rich or at least who want to collect more revenue from the rich the flat tax is a remarkably successful way of doing it. Maybe rich people are bad like some of the collectivists think but they're not stupid, or at least their financial advisors aren't stupid. So when you have very high tax rates on rich people what happens? They hide their money, they under-report their money, they find loopholes and deductions and credits. If you look at U.S. history, the history of other countries you will see a very clear relationship when tax rates are low rich people end up reporting and earning more income and governments often times collect more revenue at a lower rate then they were collecting at a higher rate. We certainly saw that in the U.S. under Reagan. We saw it with the flat tax in Russia. We saw with dramatically lower tax rates in Ireland. We see it all around the world. We see it in Hong Kong where the top 8% of tax payers pay more than half of the tax burden and it's actually closer to 75% of the tax burden. So if you want the rich to pay a lot of money give them a low-rate tax system so that they don't have any interest in trying to hide their money from the tax man.

FC: Can you tell us a little bit... I understand there are now 25 countries around the world that have a flat tax. Could you tell us a bit about some of those countries? Where they are and how they came to have a flat tax?

DM: The flat tax revolution is one of the really amazing fiscal policy stories of the last 10 years but maybe it started a bit before then. Up until 1994 you had a tiny handful of flat tax jurisdictions around the world. Hong Kong and then just by random coincidence a few other places like Jersey and Guernsey, British territories no one's ever heard of, and Jamaica, although that was a very high rate flat tax, at least at the time, of 33%. But then after the break up of communism and the collapse of the Soviet Empire, Estonia adopted a flat tax in 1994. It immediately spread to the other Baltic countries. Then it jumped to Russia in 2001 and then once Russia did it, it started spreading all over Eastern Europe and former Soviet block nations. There are now 18 former communist countries that have flat taxes. There are 25 countries overall that have flat taxes and a lot of this is being driven by three things. One, it's being driven by tax competition. Globalization means it's easier for tax payers saving and investment and labour to cross national borders and that means that if adopt a good system like a flat tax as a country you are going to attract a lot of productive economic activity into your borders so countries are figuring out this is a route to economic prosperity. So tax competition is number one. Number two, at least in the communist world, it's driven by the fact that they suffered under decades of class warfare mentality so now that they're free they'd much rather have a tax system based on real equality – treating everyone the same. Number three, success begets success. All the flat tax countries, just as we now have more than 30 countries with personal retirement accounts, countries that are doing these reforms are enjoying incredible success. So if you look at your neighbour and your neighbour's done a flat tax and your neighbour's growing faster, creating more jobs, collecting more tax revenue because of these laffer curve effects… All of a sudden you say 'I'm going to do it too.'

FC: In the Canadian context, we have one province out of ten, which is Alberta. They have single rates and other aspects that approach the ideal flat tax as you described earlier. We also have the province of New Brunswick on the Atlantic Ocean which released quite a serious discussion paper regarding a flat tax so it seems like the flat tax revolution may be beginning to come towards Canada. However, there's one other thing I wonder about which is that we pay around about half of our taxes to the federal government and around about half of our taxes to the provincial government. What would it mean if either the federal government adopted a flat tax and some provinces retained their current systems or the provincial governments in some province managed to have a flat tax even though the federal government retained its current position? Would it be a big problem or is there still some benefit to have a flat tax in one of the jurisdictions that a Canadian pays tax to?

DM: What determines people's incentives to work, save and invest is the total effective marginal tax rate. So if New Brunswick joins Alberta in the flat tax revolution that's good news but obviously is you still have very discriminatory tax rate structures being imposed by the central government then there's only so far that flat tax will take you. It's a positive step but it's . . . what's the old phrase? It's perhaps a necessary but not sufficient condition for true prosperity. We have the same issues in the United States. We have nine states with no income taxes and then we have at least seven, but I'm not quite sure on the exact number, seven states with flat income taxes and those states grow faster than the states with the so-called progressive tax rates. They create more jobs. They attract more investment. So we have this sort of tax competition going on in the U.S. and we have these states that are being rewarded for better tax policy but because our central government is still the biggest part of the fiscal pie there's only so much a state can do. So if we really want to have prosperity across the nation we need our central government, we need Washington, D.C. to have a flat tax. So I certainly recommend that provinces in Canada and states in the U.S. do what they can to have good fiscal policy but ultimately to really solve the problems and to create a more competitive, prosperous economy you also need the central government to do it as well. The U.S. and Canada are lucky in that we do have working federal systems. With provincial or state governments still having some fiscal autonomy to make their own taxation and spending decisions. That's a big advantage over these unitary countries, as they're called, where the central government decides everything and there's no competition inside the country based on fiscal policy. But, we still would both be better off if we were like Switzerland because there is federalism on steroids! The Cantons are bigger, in terms of fiscal policy, than the central government. In other words, they're the dog and the central government is the tail. Unfortunately in the U.S. the states are the tails and the central government is the dog. Canada, I think, is better than the U.S. in terms of federalism but we would both be better off moving more towards Switzerland where the central government does very little and the local or provincial governments are responsible for the major decisions.

FC: You talked about the flat tax having several aspects at the beginning. So I guess it's kind of an ideal model. If there are any policy makers listening to this, are there aspects of a flat tax that they would do well to pick up and introduce alone, even if they were not prepared to introduce the entire package?

DM: Well I don't have the familiarity with the tax system in Canada to make specific recommendations. But to the extent that Canada has some of the unpleasant provisions that we have in America like a death tax. I believe you don't have a death tax. But if you have double taxation of savings and investments, like capital gains tax, dividend taxes, taxes on savings those are some of the more economically destructive taxes and certainly any time you can lower the marginal tax rate of labour, the top marginal tax rate, that's very important because we do live in a competitive global economy, jobs and investments do cross borders and so nations that make mistakes like double taxing savings and investments, by imposing high marginal tax rates on the most productive people in an economy. Those governments are shooting themselves in the foot. You want to make sure that you have the welcome mat out for international entrepreneurship and international investment.

FC: Canada and the United States pride themselves, and I think that most people that live there are used to the idea, that we are the wealthiest or at least close to being the wealthiest countries in the world. However it seems that the flat tax revolution is happening in a lot of poorer countries who are growing faster than us.

What will it mean, say in 20 years from now, if the United States and Canada continue to have their existing tax systems and ignore the changes that are happening elsewhere?

DM: The good news is that the U.S. and Canada are among the world's most economically free countries. If you look at the Economic Freedom of the World Index or the Index of Economic Freedom we are both up there, certainly well inside the top 20. That may be more a reflection of how bad other countries are. It would be a lot better if we both became more like Hong Kong or Singapore. That having been said, there's no question that many countries around the world are now being star reformers. Today, Estonia is not nearly as rich as the U.S. or Canada on a per capita basis. But 20 years from now if Estonia continues to grow at 7 or 8% a year and the U.S. and Canada are growing at 2 and 3% a year, sooner or later the lines cross. That's not bad for the U.S. or Canada that Estonia surpasses us because it's great to have your neighbours around the world be richer but wouldn't it be good for the American and Canadian people if our governments also engaged in the reform, put in more laissez-faire policies, lower tax rates, shrank the burden of government spending? Those are things that would make families and households in our countries richer as well.

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