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TAX FREEDOM DAY: A CAUSE FOR CELEBRATION OR CONSTERNATION?

Sheena Starky
Economics Division

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INTRODUCTION

Each year, typically in June, Canadian media recognize the arrival of Tax Freedom Day, the day on which Canadian families with two or more individuals are purported to have earned sufficient income to pay their total tax bill to all levels of government for the entire year and, therefore, to be able to "start working for themselves." Critics claim that the notion of Tax Freedom Day is misleading and is calculated using a flawed methodology.

HISTORY

It is believed that an American businessman developed and copyrighted the idea of Tax Freedom Day in 1948. In 1971, the copyright for Tax Freedom Day was transferred to the Tax Foundation, which continues to produce the indicator annually for the United States and also began calculating state-specific indicators in 1990.(1) In a 1974 *Newsweek* column, economist Milton Friedman seemed to refer to a similar concept when he suggested that the United States institute a national holiday called Personal Independence Day on the day of the year "when we stop working to pay the expenses on government … and start working to pay for the items we severally and individually choose in light of our own needs and desires."(2) In Canada, The Fraser Institute began issuing annual Tax Freedom Day press releases in the early 1980s and has included the indicator in its biennial *Tax Facts* publication since 1994.

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(1) Adam Smith Institute, "Around the World in 80 Ideas," 2002, http://www.adamsmith.org/80ideas/idea/39.htm.

(2) Neil Brooks, *Tax Freedom Day: A Flawed, Incoherent, and Pernicious Concept*, Canadian Centre for Policy Alternatives, 16 June 2005, p. 10.

TAX FREEDOM DAY IN CANADA

Preliminary estimates for 2006 suggest that Tax Freedom Day in Canada occurred on 19 June, five days earlier than in 2005 and six days earlier than in 2000. The Fraser Institute attributes the change in Tax Freedom Day between 2005 and 2006 to tax relief measures announced by federal and provincial governments, including the reduction in the goods and services tax (GST) rate from 7% to 6%, which is believed to account for about 20% of the five-day change from 2005 to 2006.(3)

As a result of changes to the underlying Statistics Canada dataset, availability of historical (pre-1992) Tax Freedom Day dates is limited.(4) According to revised estimates produced by The Fraser Institute, Tax Freedom Day fell on 3 May in 1961, 30 May in 1981, 6 June in 1985 and 2 June in 1992, before following the path shown in Figure 1. Collectively, these figures seem to suggest a tendency toward increasingly later Tax Freedom Days in Canada over the past 45 years, although it is very difficult to draw strong conclusions without a complete dataset. A recent exception to the trend is the seven-day decrease between 2000 and 2001, which corresponded with tax relief measures announced in the February 2000 federal budget and the October 2000 federal economic statement and budget update.

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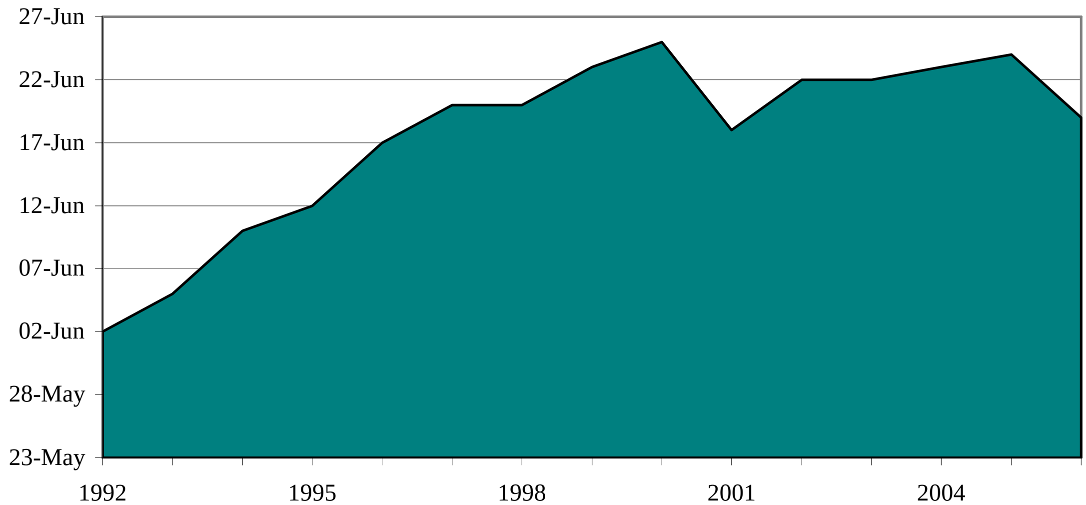
(3) The Fraser Institute, "Canadians Celebrate Tax Freedom Day on June 19th," 16 June 2006, http://www.fraserinstitute.ca/shared/readmore.asp?sNav=nr&id=731.

(4) The 2002 Survey of Labour and Income Dynamics replaced the 1998 Survey of Labour and Income Dynamics as the dataset for the Social Policy Simulation Database and Model (SPSD/M).

Figure 1: Tax Freedom Day in Canada, 1992-2006



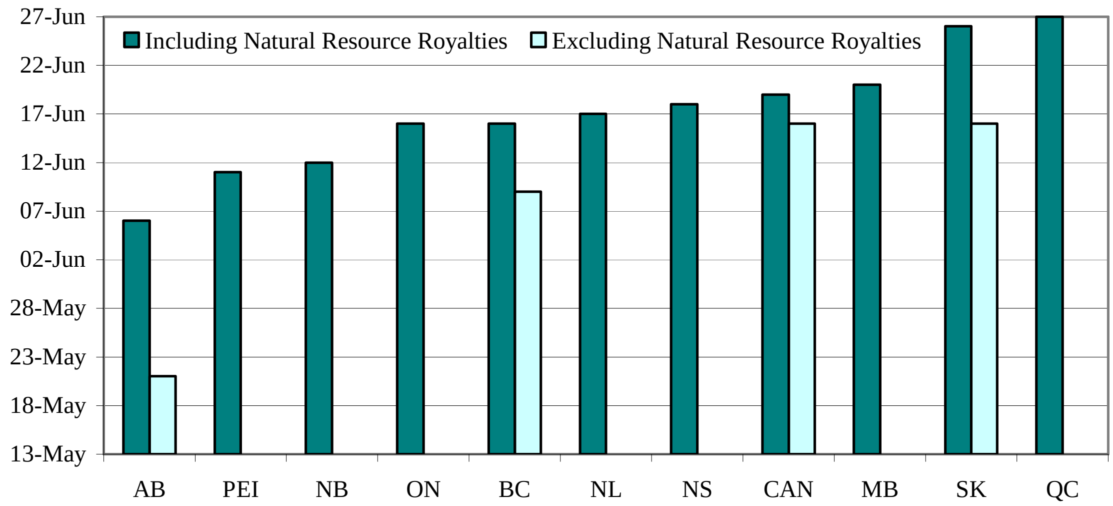
Notes: Based on total taxes as a percentage of cash income for families with two or more individuals.

Sources: Prepared by the Library of Parliament using data provided in personal correspondence with Niels Veldhuis, Associate Director, Fiscal Studies, The Fraser Institute, 28 June 2006.

From a provincial perspective, preliminary estimates indicate that Tax Freedom Day occurred earlier in all provinces in 2006 than it did in 2005. Figure 2 shows forecasted Tax Freedom Days for 2006 for each province, both with and without natural resource royalties for British Columbia, Alberta, Saskatchewan and Canada.(5)

(5) According to The Fraser Institute, there is debate about whether natural resource royalties are a form of taxation or a conversion of an asset into an income stream.

Figure 2: Tax Freedom Day in Canada, by Province, 2006



Notes: Based on total taxes as a percentage of cash income for families with two or more individuals.

Source: Prepared by the Library of Parliament using data provided in "Tax Freedom Day Tables – 2006," The Fraser Institute, 21 June 2006, http://www.fraserinstitute.ca/shared/readmore.asp?sNav=nr&id=613.

METHODOLOGY

The Fraser Institute calculates Tax Freedom Day in Canada using its Canadian Tax Simulator (CANTASIM), of which Statistics Canada's Social Policy Simulation Database and Model (SPSD/M) is a component.(6) The following steps form the basis of the calculations:

(1) Total taxes paid = income taxes + sales taxes + liquor, tobacco, amusement and excise taxes + auto, fuel and motor vehicle licence taxes + social security, medical and hospital taxes + property taxes + import duties + profits tax (corporate income tax) + natural resources taxes + other taxes(7)

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(6) The Social Policy Simulation Database and Model (SPSD/M) is a microsimulation model that facilitates estimation of the income redistributive effects and cost implications of changes to the Canadian personal taxation and cash transfer system.

(7) A common question is why the calculation of total taxes paid includes corporate income tax. In a 31 January 1999 press release, The Fraser Institute explains that corporations are "machinery, contracts, office space, employees, shareholders, bondholders, and so on. These parts work together to make income for people, and corporate tax is, therefore a tax on people. The corporation itself cannot pay the tax because it is not the final destination of the income it generates. In the end, people pay the corporate tax."

(2) Cash income = wages and salaries + government transfers + pension payments + interest and dividends + farm income + self-employment income

(3) Percentage of cash income paid in tax = total taxes paid ÷ cash income

(4) Number of days required to pay total tax bill = Percentage of cash income paid in tax X 365 days

(5) The number of days required to pay the total tax bill is translated into a calendar date, which becomes known as the Tax Freedom Day for that year.

The Fraser Institute reports Tax Freedom Day for a hypothetical family whose income is equal to the average income of all families with two or more members.

CRITICISMS

While the idea of Tax Freedom Day is intuitively appealing and media-friendly, the concept does not enjoy unanimous support in Canada or in other countries where similar reports on Tax Freedom Day exist.(8) Specific criticisms of the Tax Freedom Day indicator in Canada centre on methodology and tend to be related to three definitions:

- “average Canadian family;”
- income; and
- taxes.

Critics such as the Canadian Centre for Policy Alternatives dispute The Fraser Institute’s choice of methodology, arguing that it systematically exaggerates the tax burden of average Canadians by overestimating taxes paid and/or by underestimating taxpayers’ ability to pay their taxes.

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(8) In Canada, the Canadian Centre for Policy Alternatives published *Tax Freedom Day: A Flawed, Incoherent, and Pernicious Concept* in June 2005, outlining what it believes to be the misleading nature of Tax Freedom Day. In the United States, the Center on Budget and Policy Priorities published *Tax Figures Do Not Represent Middle-Income Tax Burdens: Figures May Mislead Policymakers, Journalists and the Public* on 7 April 2005.

A. Definition of the "Average Canadian Family"

Critics dispute The Fraser Institute's representation that Tax Freedom Day is an estimate of the tax burden of the "average Canadian family" on the basis that the average income of Canadian families is greater than the income of the average (or typical) Canadian family. They advocate the use of the median income of Canadian families – that is, the income level at which 50% of Canadian families earn more and 50% earn less – rather than the statistical average income of Canadian families.(9) Moreover, the Canadian Centre for Policy Alternatives questions The Fraser Institute's decision to base its calculations on families with two or more members, who have, on average, greater incomes than unattached individuals.(10) To the extent that the Canadian tax system is progressive – that is, Canadians with lower incomes pay a smaller share of their total income in taxes than Canadians with higher incomes – these methodological choices would overestimate the taxes paid by typical Canadians.

B. Definition of Income

The Fraser Institute uses a measure of "cash income,"(11) based on a comprehensive measure of income included in Statistics Canada's National Accounts Framework, in its calculation of Tax Freedom Day. Critics claim that this choice is a narrow measure of income that underestimates Canadians' ability to pay taxes by excluding non-cash items such as interest accumulated on income from their pension plans and fringe benefits from employment, as well as cash items such as gifts, bequests and capital gains, which are not included in the National Accounts. The Fraser Institute maintains that many people think of cash income as their total income and, therefore, "cash income is a useful tool in describing the tax burden because it does not force people to go through arithmetic gymnastics to arrive at their total tax income before tax to get an idea of how large the total tax burden is."(12)

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(9) Statistics Canada reports that, in 2004, the *average* total income (before income taxes and after government transfers) of a Canadian family (including families of two or more people as well as unattached individuals) was $61,000 while the *median* total income was $47,200.

(10) Statistics Canada reports that, in 2004, the average total income of families of two or more people was $76,100, compared to $31,200 for unattached individuals.

(11) There are various methods of estimating income, ranging (in order of increasing comprehensiveness) from cash income, to total income after taxes, to total income before taxes. The elements of "cash income" are outlined in calculation (1) in the Methodology section. "Total income" includes cash income plus non-cash items such as fringe benefits from employment, investment income from insurance companies and pension plans, imputed interest, the value of food from farms and corporate retained earnings. "Total income before taxes" includes total income plus property taxes, profits tax (corporate income tax) and indirect taxes (e.g., payroll taxes).

(12) Neils Veldhuis and Michael Walker, *Tax Facts 14*, The Fraser Institute, April 2006, pp. 35-36.

C. Definition of Taxes

Historically, The Fraser Institute has considered all sources of revenue used to calculate equalization payments in its calculation of total taxes paid. Critics suggest that this choice overstates total taxes paid by treating certain non-tax sources of government revenue (e.g., sales of goods and services or user fees, licences and permits, royalties, rentals) as taxes. One specific example cited is the royalties paid by oil and gas and mining companies for the extraction of oil and gas. In recognition of the controversy regarding the classification of natural resource royalties as taxes, The Fraser Institute publishes figures with and without natural resource royalties for provinces that have significant natural resource revenues, as shown in Figure 2.

Collectively considering the income and tax measures chosen by The Fraser Institute, the Canadian Centre for Policy Alternatives has expressed concern regarding what it views as inconsistent treatment of income and taxation in the calculation of Tax Freedom Day: "… since [The Fraser Institute attributes] all taxes paid in Canada to individual families – including those paid by employers, corporations, and taxes paid on capital gains – [its] calculations treat families as having paid a good deal of their taxes out of income they are not treated as having received."(13)

D. One Side of the Story?

More fundamentally, critics question the usefulness of the Tax Freedom Day indicator since it considers only the tax burden on Canadians without regard to the benefits received in exchange. As the Centre for Research and Information on Canada has noted: "Others might prefer to call … [Tax Freedom Day] … 'free public services day' – since it could be argued that after that date, Canadians could send their children to school, seek medical treatment, drive on roads and highways, drink clean water, use Canadian currency, and send soldiers to fight the war against terrorism without having to pay a penny for the privilege."(14) The Fraser Institute defends its Tax Freedom Day indicator, however, arguing that it represents

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(13) Brooks, 2005, p. 5.

(14) "Equalization and 'Tax Freedom Day'," in *Sharing the Wealth: Choices for the Federation*, The CRIC Papers, Centre for Research and Information on Canada, September 2002, pp. 21-22, http://www.cric.ca/pdf/cahiers/cricpapers_sep2002.pdf.

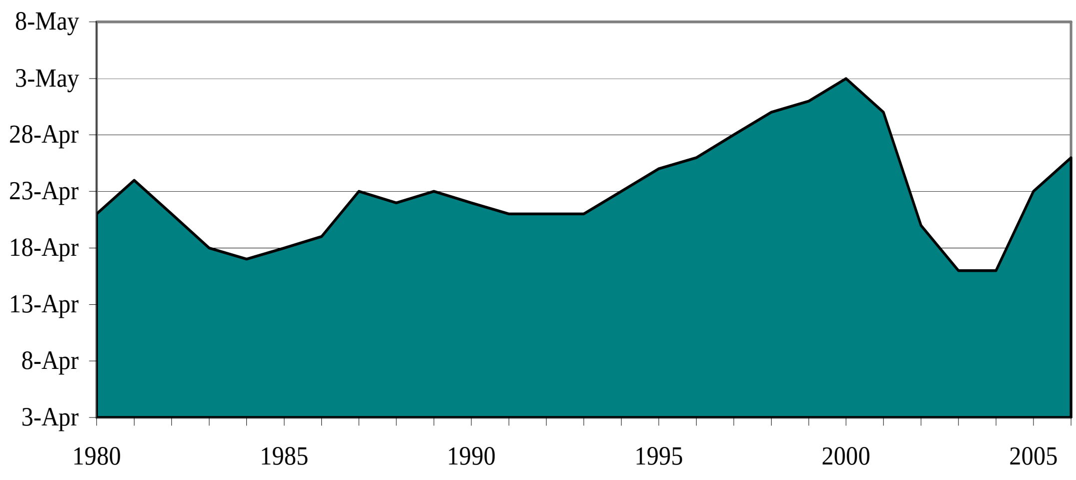
"the price that is paid for a product – government. It has nothing to say about the quality of the product, how much of it each of us receives, or whether we get our money's worth."(15)

TAX FREEDOM DAY IN THE UNITED STATES AND IN THE UNITED KINGDOM

Organizations in other countries, including the United States and the United Kingdom, also calculate Tax Freedom Days for their respective taxpayers; however, differences in methodology and/or public finance data collection and categorization make comparisons between countries inadvisable.

In the United States, the Tax Foundation has calculated Tax Freedom Day annually since the early 1970s and has also completed calculations using historical figures dating back to 1900. Figure 3 shows how Tax Freedom Day in the United States has changed between 1980 and 2006.

Figure 3: Tax Freedom Day in the United States, 1980-2006



Note: Leap day (29 February) is omitted so that dates are comparable over time.

Source: Curtis S. Dubay and Scott A. Hodge, "America Celebrates Tax Freedom Day," *Special Report*, Tax Foundation, No. 140, April 2006, p. 1; reproduced by the Library of Parliament.

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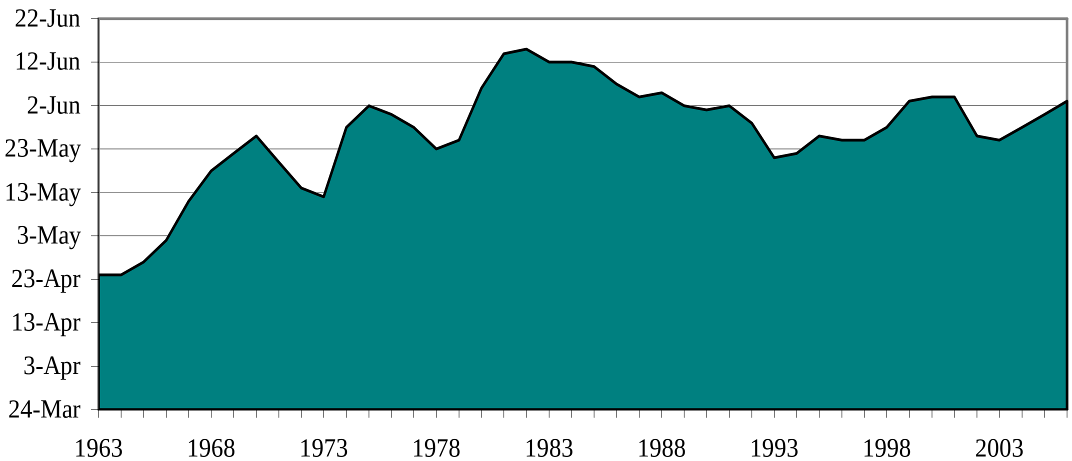
(15) For information on this subject, The Fraser Institute refers readers to *Government Spending Facts 2*, published in 1994, and to its government report cards.

In the United Kingdom, Tax Freedom Day is calculated by the Adam Smith Institute. As Figure 4 demonstrates, Tax Freedom Day in 2006 arrived approximately 40 days later in 2006 (3 June) than in 1963 (24 April).

Figure 4: Tax Freedom Day in the United Kingdom, 1963-2006



Notes: Tax Freedom Day in leap years (1964, 1968, 1972, 1976, 1980, 1984, 1988, 1992, 1996, 2000, 2004) was increased by one day in order to facilitate comparison across years.

Source: Adam Smith Institute, "Tax Freedom Day," 2006, http://www.adamsmith.org/tax/short-history.php; prepared by the Library of Parliament.

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C. United Kingdom

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