

# THE FLAT TAX EFFECTS – THEORETICAL AND EMPIRICAL EVIDENCE IN WESTERN AND EASTERN EUROPEAN COUNTRIES

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*This paper takes a close look at the advantages and disadvantages of the flat tax and looks at its proven benefits and failings in some European countries which adopted it and its theoretical or possible effects on the economies of other European countries which refuse the idea of a single tax rate for all types of revenues. Although there is a basic format of the flat tax, there are multiple flat tax proposals that have been adopted in different central and Eastern European countries. The Western Europe feels differently. With heavy budget obligations, these countries reject flat taxes because they say their countries wouldn't be able to afford a cut in their tax revenues. But in the same time they are struggling to compete with the growing reliance on flat taxes of the East.*

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## **1. Introduction**

Nowadays there is an extensive debate on what is called the major fiscal phenomenon of the last two decades: the flat tax. The flat tax is a tribute to fiscal simplification, a principled value held and espoused by the first great economist, Adam Smith. He advocated certainty, clarity and convenience as to an individual's own burden. These concepts typify a flat tax and demonstrate the general themes of classical liberalism.<sup>219</sup> The flat tax defined later by Hall and Rabushka is a cash-flow business tax plus wage tax at same rate. But the term 'flat tax' is now often used especially to designate a family of personal income taxes which are assemble but not identical. Early experiences of flat tax reforms like the ones in Hong Kong and Channel Islands received little attention. Current interest sparked by the flat taxes of Eastern European transition countries from late 1990s, especially Russia in 2001 in which case the introduction of a low rate was quickly followed by 25 percent increase in real personal income tax revenues.<sup>220</sup> Western Europe feels differently. To support large governments and sizable welfare payouts, many Western European countries impose a triple-tiered tax regime of Value-Added Taxes, akin to a sales tax, high taxes on corporate revenue, and personal tax rates that can exceed 50 percent. Eastern Europe's cheaper labor market and growing reliance on flat taxes leave Western European economies struggling to compete.<sup>221</sup>

## **2. Advantages and disadvantages of a flat tax**

Why is the flat tax seen as a magic formula for any fiscal system on the planet? Flat-tax advocates - and there are many- say that it encourages tax compliance and adds to the flow of foreign investors. In short the main benefits of a fiscal system based on a flat tax are the following:

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219 Evans, Anthony J., Flat tax: ideas and interest, Open Republic: July / August / September 2005, [http://www.openrepublic.org/open\\_republic/20050701\\_vo11\\_no1/articles/20050619\\_ft.htm](http://www.openrepublic.org/open_republic/20050701_vo11_no1/articles/20050619_ft.htm).

220 Keen Michael (International Monetary Fund, FAD), The Flat Tax Experience and Evidence, <http://www.cef-see.org/index.php?location=1094>.

221 Tzortzis, Andreas, Flat tax movement stirs Europe, <http://www.csmonitor.com/2005/0308/p01s03-woeu.html>.

- Reduced compliance costs: The complexity is a hidden tax, because the costs of determining a global progressive tax are sometimes extremely high. The flat tax instead is simple and clear for everyone and the spending with taxation is lower.
  - Reduced avoidance & evasion: A simpler tax system reduces the scope for legal tax avoidance, by removing many of the deductions, thresholds and anomalies on which most avoidance is based, and makes enforcement of taxes easier, reducing the possibility of illegal tax evasion. In addition replacing a system of higher rate taxes with a single, low, flat rate reduces the motivation for avoidance.
  - Instant Wealth Creation. According to Harvard economist Dale Jorgenson, tax reform would boost national wealth. It would do this in part because all income-producing assets would rise in value since the flat tax would increase the after-tax stream of income that they generate.
  - Reduced disincentives: Income tax is a great disincentive to investment (which has to be profitable enough to cover the tax as well as to give a return for the investor), to business start-ups or expansion (with few exceptions the tax system is usually more willing to tax profits than to give relief for losses), and for employment.
  - Fairness: some may say fairness is the greatest virtue of the flat tax. It is based on the idea of fairness learned in grade school - everyone should be treated the same. Rather than have politicians and their favored interests decide - for their own reasons - who should get favored treatment and who should be penalized, the flat tax sets a single objective standard. No matter how much money you make, what kind of business you are in, you will be taxed at the same percentage as everyone else.
  - Global competition brings economic growth: in the increasingly integrated global economy, nations are waging a battle between governments to attract investment and skilled workers by overhauling their tax codes to create a more attractive business environment. Tax competition facilitates economic growth by encouraging policymakers to adopt sensible tax policy. Today, thanks to competition, the average corporate tax rate in the European Union is less than 30 percent.<sup>222</sup>
- But whilst such a system looks beguilingly simple, beneath the surface the practical details are always more complex. Wherever flat taxes are used, they are always exercised in conjunction with more complex systems, merely adding another layer of regulations.
- There some hid disadvantages which cannot be seen only after a deeper analysis:
- Flat taxes are inherently regressive, meaning that the poor pay proportionately more than the rich, and so undermine the social democratic principle of richer helping poorer citizens for the public good. Such inequity is recognized and resented.
  - A main effect of the flat tax which can appear on the long term is the polarization of the nation's wealth in the hand of the few and the wealthy, giving the fact that a flat tax regime leaves more financial resources at the disposal of the rich.
  - The flat tax conducts to an unhealthy fiscal competition among different states. This phenomenon amplifies the migration of the capital and work force. This disadvantage can be eliminated by adopting some harmonization procedures which become absolutely necessary nowadays.
  - Flat taxes are too simple, losing necessary flexibility. Goods and services vary, so it would be wrong to tax luxury versions at the same rate as economy ones, or children's textbooks at the same rate as adult novels. Income taxes, by contrast, may encourage more labor to make up any shortfall, whilst tax credits given to low earners can ensure marginal rates stay below 100%.
  - Simply shifting administrative costs onto businesses will not help, as the Australian experience has shown that moving to flat or indirect taxes hit small business. An overly simple system does

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<sup>222</sup> Mitchell, Dan, Heritage Foundation, Tax Competition And Fiscal Reform: Rewarding Pro-Growth Tax Policy, <http://www.cato.org/events/russianconf2004/papers/mitchell.pdf>.

not allow in time for additional incentives to potential investors, causing a loss of international competitiveness.

- The transition to a new system can be complex and costly to begin with, leading to a period of confusion. The ability to discover new means of evasion will always be present, especially during the changeover. They are also inflexible, unlike income taxes where 'fiscal drag' and 'fiscal boost' act as automatic stabilizers in boom and bust periods respectively.<sup>223</sup>

### **3. The flat tax effects – empirical evidence in Eastern Europe**

Flat taxes used to be the norm in Western countries. But in the 19th century, Communism founder Karl Marx listed a "heavy progressive" tax as a top priority. Soon, higher income-earners were being taxed at higher rates around the world. The irony today is that every flat-tax country (except Hong Kong) is a former Communist nation.

Since 1994, the flat tax has become an important part of the fiscal landscape in Central and Eastern Europe, from Estonia in the North, to Russia in the East, Georgia in the South, and Slovakia in the West. They were joined by Latvia, Ukraine, Serbia, Romania, Macedonia, Albania and the Czech Republic.

Only three actual reforms have been examined in the literature: the 2001 Russian reform by, among others, Ivanova et al. (2005), the 2004 reform in the Slovak Republic by, among others, Brook and Leibfritz (2005) and partially the 2005 Romanian tax reform by the Group of Applied Economy. In the Russian case, the reform was followed by significant real growth in tax revenue, but there was no strong evidence that this was caused by the flat tax or by improved law enforcement, nor could any positive labor supply responses be identified. The Slovakian reform was expected to be revenue neutral, to increase the level and efficiency of capital formation and enhance the incentives of unemployed workers to seek work. While it is true that most real world reforms have been very recent, research on their effects is probably also limited due to the lack in those countries of high-quality (micro-) data for the pre-reform period.

#### ***Russia: the magic shift***

The Russian flat tax experiment is particularly interesting: after the introduction of flat taxes, and effective personal income tax rate cuts, tax revenues increased substantially and almost immediately. Furthermore, they increased much faster than labor supply and output.<sup>224</sup>

Russia introduced in 2001 a flat 13 percent personal income tax rate, replacing the three tiered, 12, 20 and 30 percent previous rates. The tax exempt income was also increased, further decreasing the tax burden. Considering social tax reforms enacted at the same time, tax rates were cut substantially for most taxpayers. However, personal income tax revenues have increased significantly: 46 percent in nominal and 26 percent real terms during the next year. Even more interesting personal income taxes revenues have increased from 2.4 percent to 2.9 percent of GDP—a more than 20 percent increase relative to GDP. Personal revenues continued to increase to 3.3 percent during the next year, representing a further 14% gain relative to GDP. Furthermore, even official estimates showed increased tax compliance.<sup>225</sup>

One study of the IMF shows that tax rate cuts in Russia increased tax compliance and that tax revenues increase in response. Tax rate cuts can affect tax revenues through two main channels: Affecting the tax base or affecting compliance with the tax rules.<sup>226</sup>

#### ***Slovakia: the Slavic tiger***

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223 Rose Jacqueline, Flat Tax, [http://www.idebate.org/debatabase/topic\\_details.php?topicID=169](http://www.idebate.org/debatabase/topic_details.php?topicID=169).

224 Tamás K. Papp, Előd Takáts, Tax Rate Cuts and Tax Compliance—The Laffer Curve Revisited, 2008 International Monetary Fund, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1087186](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1087186).

225 Ivanova, Anna, Michael Keen and Alexander Klemm (2005) The Russian Flat Tax, Economic Policy, July: p. 397.

226 Tamás K. Papp, Előd Takáts, Tax Rate Cuts and Tax Compliance—The Laffer Curve Revisited, 2008 International Monetary Fund, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1087186](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1087186).

In 2003 Slovakia has adopted flat tax of 19% both for corporation and individuals. Before deciding to implement the new system, the Slovak government has conducted five surveys in order to eliminate a negative effect of the flat tax on the economy. "More transparency, less tax dodging", this was the slogan used by Slovakia in implementing the flat tax system. In 2004 Slovakia received from the World Bank the title of "The most reformed economy of the globe". The flat taxing system has replaced a mechanism with 90 tax exceptions, 19 non taxed income sources, 66 exonerations and 27 products with different level of taxation. In the same time, Slovakia has eliminated the VAT reduced rates and established a new unique rate for the VAT of 19%. The consequences were: in 2003 in Bratislava there were 22 new projects and 7500 new jobs created and in 2004 there were 47 new projects and 12700 jobs were created.

The flat tax and other reforms have improved economic performance. Economic growth, after adjusting for inflation, has averaged 6.6 percent per year. The flat tax reform has generated a supply-side feedback effect. Because lower income tax rates stimulated additional productive behavior, personal income tax revenue collections in the first year were higher than forecasted by static revenue estimates. Likewise, value-added tax collections were lower than forecast in response to the generally higher tax rate. Slovakia's system is widely seen as a model for other nations, leading one economist to state, "The Slovak public finance reform will be studied in economic textbooks all over the world one day."

A study conducted by OECD Economic Department has shown the following results about the effects of the flat tax in Slovakia: First, the reforms were expected to improve both the level and efficiency of capital investment in Slovakia – although further improvements could have been made by eliminating the double taxation on projects financed by retained profits. Second, the combination of the tax and social benefit reforms has enhanced the incentives for unemployed workers to seek work, which should result in higher labour supply. Labour demand should also have increased, thanks to the more flexible labour market. However, as overall taxes on labour remain high, labour demand for very low skilled workers may not pick up without further reforms to reduce the cost of employing such workers. With respect to equity considerations the assessment is less clear cut. On the one hand the flat personal income tax has benefited both low income earners and very high earners, particularly those with families, while middle-income earners, particularly single earners appear to be somewhat worse off. The increase in VAT and the welfare reform also have distributive effects. The net result of these reforms has been a significant cut in the real incomes of social beneficiaries who are not working. On the other hand, by raising labor productivity and reducing structural unemployment the reforms have the potential to benefit the low-skilled population also – provided other public policies are in place to facilitate this outcome.<sup>227</sup>

#### ***Romania: unaccomplished flat tax reform***

Romania adopted 16% flat tax regime in 2005. The tax revenues of the public budget increased the following years substantially, but the increase was generated mainly by the revenues from VAT and not by the personal income tax revenues and corporate income tax revenues. This indicates the fact that the reform stimulated consumption and not investment and tax compliance. A study conducted by the Romanian research organization GEA (Group of Applied Economics) shows that the effects of the flat tax on income distribution were not the ones which were predicted initially. 40% of the benefits of the flat personal income tax were experienced by the very high earner, which represent 10% of the population. 84% of the high earners' flat tax benefits and 74% of low earners' flat tax benefits were consumed.

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227Brook, A. and W. Leibfritz (2005), "Slovakia's Introduction of a Flat Tax as Part of Wider Economic Reforms", OECD Economics Department Working Papers, No. 448, OECD Publishing, p. 3, <http://titania.sourceoecd.org/vl=833403/cl=13/nw=1/rpsv/cgi-bin/wppdf?file=51g19fftr46k.pdf>.

The labor incentives were very wick taking in consideration the fact the marginal effective tax rate for the ones who gain less than the average wage is steel high. The METR lowers significantly for high earner how already had important salaries.<sup>228</sup>

In the same time the 16 percent flat tax registered in one way a success in relaunching Romania's economic growth, not only because it provided citizens increased buying power, but also because it made it less expensive for companies to hire top managers.

#### 4. The flat tax effects – theoretical evidence in Western Europe

In the Western Europe, home to governments that generally profess the "social market economy" of high taxes and redistribution of income have appeared the first signs that the flat tax could become a reality. The increasing of unemployment and the decreasing rate of economic growth may change the view on the taxation policy. The flat tax is the central point of discussion regarding the taxation policy in Great Britain, Germany, Italy and Greece.

The question that follows is in what way the flat tax would affect the income distribution and the work incentives in these countries.

As a recent study shows that in terms of distributional measures two groups of countries were differentiated: inequality, polarization, (relative) poverty and richness are rather high in Southern European countries (Greece, Portugal and Spain) and the UK, whereas they are rather low in Continental Europe (Austria, Belgium, Germany, Luxembourg) and Finland. In terms of redistribution two different groups became visible: progression is rather low in Finland, the UK, Germany, Austria and the Netherlands, whereas it is rather high in Belgium, Greece, Portugal, Luxembourg and Spain. When looking at both dimensions a matrix with 4 groups emerges (see Table 1) resembling the modified typology of Esping-Andersen<sup>28</sup>: Mediterranean countries with high inequality and progression, Anglo-Saxon (or liberal) with high inequality and low progression, Continental European (or conservative) with low inequality and high progression and Nordic (or social-democratic) countries with low inequality and progression. This classification, however, is not completely consistent with Espying-Andersen (1990) as Germany and Austria are classified as social-democratic welfare states whereas Espying-Andersen sees them as prototypical conservative Continental European welfare states.<sup>229</sup>

**Table 1: Classification of countries based on the existing tax-benefit systems**

		Inequality, Poverty, Richness	
		Low	High
Progression	Low	AT, FI, GE (social democratic)	UK (liberal)
	High	BE, LU, NL (conservative)	GR, PT, SP (Mediterranean)

All in all the study results show that revenue neutral at flat tax reform cannot overcome the fundamental equity-efficiency trade-off. However, in some cases such as Greece, Portugal and Spain an increase in both equity and incentives is possible. These countries have the typical Mediterranean welfare state regime, characterized by high inequality, poverty, richness and polarization of the income distribution. These distributional characteristics imply a lack of a well established middle class. Therefore, the distributional effects of a flat tax regime are less adverse than in countries with a more equal income distribution. Switching to a tax regime in this setting

228Voinea, Liviu, Mihaescu, Flaviu, The Impact of the Flat Tax on the Inequity in Romania, The Group of Applied Economy, 2008, <http://www.gea.org.ro/index.htm>.

229Paulus, Alari, Peichl, Andreas, Effects of flat tax reforms in Western Europe on equity and efficiency, Institute for Social and Economic Research, 2008, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1278921](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1278921).

can reduce inequality and increase efficiency in terms of labour supply incentives. However, the resulting .at rates are rather high.<sup>230</sup>

## 5. Conclusion

The flat tax systems in Eastern European countries proved their benefits and failings. The recent economic crisis tends to affect a lot these economies and may also affect their fiscal strategy. But on the short term the abortion of the flat tax regimes is unlikely to happen.

In most Western European countries with mature tax systems which are the result of the past political redistributive game over many generations, the most likely losers from a flat tax are likely to be the past beneficiaries—the middle classes—who will use the democratic process to resist it. The back tracking on the proposal in the US, Germany and probably in the UK suggests a full-blooded flat tax, may be infeasible in these mature tax systems. Thus, the future of the flat tax number might lie in countries which, like the East Europeans, are moving from the plan to the market.<sup>231</sup> But the economic crisis can also change the fiscal game and the introduction of flat tax regimes might be the winning card for the economies of some of these countries.

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<sup>230</sup>ibidem.

<sup>231</sup> Lal, Deepak, The Flat Tax for Developing Countries, [http://www.cato.org/pub\\_display.php?pub\\_id=6009](http://www.cato.org/pub_display.php?pub_id=6009).