

Box 10

FLAT TAXES IN CENTRAL AND EASTERN EUROPE

Over 20 countries in the world, including five central and eastern European Member States and seven EU neighbouring countries, have introduced a so-called “flat tax” (initially the three Baltic countries in 1994-1995, followed since 2001 by a second wave of countries including Russia, Serbia, Ukraine, Slovakia, Georgia, Romania, the former Yugoslav Republic of Macedonia, Montenegro and Albania – see table). The “flat tax” concept is usually associated with the academic works of Hall and Rabushka,¹ who consider a single tax rate applied to both personal and corporate income beyond a given threshold or “basic allowance”. In practice, however, none of the aforementioned countries has adopted a pure flat tax system. The actual tax reforms have departed from the “single tax rate” principle and given rise to a variety of tax schedules. In particular, they differ in the level of the basic income allowance to be exempted from taxation, the level of statutory tax rates for personal and corporate income and the definition of tax bases, for instance regarding the tax treatment of dividends.

1 Hall, R. E., and Rabushka, A. (1983), “Low Tax, Simple Tax, Flat Tax” (New York: McGraw Hill); 1985, “The Flat Tax” (Stanford: Hoover Institution Press).

Flat taxes in selected EU Member States and neighbouring countries

Country	Flat rate adopted	Personal income tax rate (in %)			Corporate income tax rate (in %)		
		Before reform	After reform	2007	Before reform	After reform	2007
Estonia	1994	16-33	26	22 ¹⁾	35	26	22 ¹⁾
Lithuania	1994	18-33	33	27 ²⁾	29	29	15
Latvia	1995	25-10 ³⁾	25	25	25	25	15
Russia	2001	12-30	13	13	15	35 ⁴⁾	24
Serbia	2003	10-20	14	14	20	14	14
Ukraine	2004	10-40	13	15	30	25	25
Slovakia	2004	10-38	19	19	25	19	19
Georgia	2005	12-20	12	12	20	20	20
Romania	2005	18-40	16	16	25	16	16
FYR Macedonia	2007	15-24	12	12 ⁵⁾	15	12	12 ⁵⁾
Montenegro	2007	16-24	15	15 ⁶⁾	15-20	9	9
Albania	2007	5-30	10	10 ⁷⁾	20	10	10

Comparison with the three largest euro area countries in 2007:

	Personal income tax rate (in %)	Corporate income tax rate (in %)
Germany	15-42	38.70 ⁸⁾
France	5.5-40	33.33
Italy	23-43	33

Sources: Keen, M., Kim, Y. and Varsano, R. (2006), “The ‘Flat Tax(es)’: Principles and Evidence”, IMF Working Paper WP/06/218; Nicodème, G. (2007), “Flat tax: Does one rate fit all?”, *Intereconomics: Review of European Economic Policy*, 42(3), 138-142; European Commission’s “Taxes in Europe” database; World Bank; national finance ministries; Federation of International Trade Associations.

Note: In italics: non-EU countries.

1) To be reduced gradually to 20% by 2009.

2) To be reduced to 24% in 2008.

3) Regressive schedule.

4) Including the 5% tax levied by municipalities.

5) To be reduced to 10% in 2008.

6) To be reduced to 9% by 2010.

7) As of 1 July 2007.

8) All-in rate combining the nominal rate of 25% plus a local profit rate and surcharges; to be reduced to 29.83% in 2008.

This box takes a closer look at the main theoretical arguments regarding the introduction of flat taxes and describes the recent experiences with such reforms in the aforementioned countries.

According to the academic literature, a key argument in favour of introducing a flat tax lies in its simplicity: a characteristic which is expected to improve transparency, cut administrative costs and increase compliance. This positive outcome is especially expected in countries previously affected by recurrent tax avoidance. In addition, flat taxes are sometimes intended to reduce tax distortions and thereby improve economic efficiency. In particular, flat taxes on corporate and personal income can reinforce incentives to work, invest and innovate if they reduce the tax burden compared with the pre-reform level. It has also been argued that such reforms could be self-financing if they indeed contribute to higher investment, employment and output growth.

As single tax rates are more visible than progressive tax schedules, they also facilitate cross-country comparisons. In a context of increased international economic integration and capital and labour mobility, especially within the EU, this may lead countries to set flat tax rates at a low level in order to attract mobile production factors and tax bases. This puts a constraint on the high-tax countries. In this regard, the academic literature points to a potential “race to the bottom” in tax rates that could erode tax revenues and result in the underprovision of some public goods, such as effective public administration and high-quality infrastructures and education systems – while these are also crucial assets to attract mobile production factors.

Furthermore, flat taxes raise equity issues as they affect the personal income distribution. Several recent academic studies², simulating the adoption of flat tax systems in European countries, come to the conclusion that although flat taxes could improve economic efficiency in certain cases, this would be at the expense of vertical equity. However, a counterargument to this finding is that redistribution objectives may be better achieved through appropriately designed government transfer schemes.

In practice, empirical reports provide mixed results on the impact of flat tax systems. The expectations of greater simplicity have not always been fulfilled. Some country studies³ find positive effects of flat taxes in terms of simplicity and compliance. Other country case studies⁴ show that simplicity in tax systems has increased only marginally, whereas the complexity associated with various exemptions and the fiscal treatment of certain categories of income remains. These findings suggest that complexity does not necessarily stem as much from progressive tax rates as from the definition of the tax base and options for exemptions.

On incentives to work, invest and innovate, empirical investigations for the Baltic countries, Georgia, Romania, Russia, Slovakia and Ukraine do not find clear-cut evidence that flat taxes indeed have the beneficial consequences expected. The new, flat statutory tax rates for personal and corporate income are not always low. In most countries of the second wave of tax reforms,

2 For instance, Fuest, C., Peichl, A. and Schaefer, T. (2007), “Is a flat tax politically feasible in a grown-up welfare state?”, FIFO-CPE Discussion Paper, 07-6, and several papers published in the *IB Review*, Institute of Macroeconomic Analysis and Development, 40(1-2): 69-153.

3 Vanasaun, I. (2006), “Experience of flat income tax: The Estonian case”, *IB Review*, 40(1-2): 101-106; Saavedra, P., Marcincin, A., and Valachy, J. (2007), “Flat income tax reforms”, in Grey, C., Lane, T. and Varoudakis, A. (2007), “Fiscal Policy and Economic Growth. Lessons for Eastern Europe and Central Asia”, World Bank.

4 Keen, M., Kim, Y. and Varsano, R. (2006), “The ‘Flat Tax(es)’: Principles and Evidence”, IMF Working Paper WP/06/218.

the personal income flat tax rate was set at or just below the lowest of the pre-reform marginal tax rates, but in Lithuania and Latvia it was fixed at the level of the highest marginal rate (see table). Nor has econometric analysis found evidence of enhanced work incentives, at least in the case of Russia.⁵ The statutory flat tax rates on corporate income are in most cases below those of the largest euro area countries. However, this comparison is blurred by significant differences in tax base definitions.

Furthermore, there is no clear evidence that the introduction of flat taxes has been self-financing, although reports do not point to dramatic deteriorations in tax revenues either. In Slovakia, personal and corporate income tax revenue dropped (by respectively 0.8% and 0.2% of GDP) in the first year of the reform but improved thereafter.

As for economic growth, although central and eastern European countries have recorded high real GDP growth rates, this favourable result may be independent from the introduction of flat taxes. Empirical analyses remain cautious in establishing causality, as the tax reforms were generally part of a comprehensive set of far-reaching fiscal and structural reforms that may have played a stronger role than flat taxes alone.

Regarding distributional effects, empirical investigations do not always find clear signs of a reduction in the degree of tax progressivity, especially when flat taxes only concern part of the total tax system and do not cover social security contributions. On the one hand, in the countries where the personal income flat tax rate is higher than the lowest pre-reform marginal tax rate, the basic allowance was not always increased and was in certain cases reduced (Latvia), implying that the taxes paid by the poorest taxpayers have increased and progressivity has declined. On the other hand, the adoption of a flat tax in Slovakia appears to have reinforced tax progressivity, through the increased role of tax credits and allowances.⁶

This overview of the theoretical arguments and empirical evidence for central and eastern European countries leads to the following conclusions. First, flat taxes do not per se suffice to simplify tax systems, as complexity is mostly attributable to the definition of the tax base and, in particular, exemptions and loopholes. Better practices in this regard, as well as fighting tax fraud, and modernising and strengthening tax administration, would contribute to increasing transparency and improving tax compliance. Second, the fact that, in most countries, the introduction of a flat tax was accompanied by major structural reforms makes it difficult to isolate the impact of flat taxes on macroeconomic outcomes as well as tax revenues. Third, the flat tax rates on personal income tend to be lower than the top marginal tax rates under the previous system, and statutory corporate income tax rates in flat-tax countries are usually lower than in the euro area. While cross-country comparisons are affected by differences in the definitions of tax bases, they point to accrued downward pressure on tax rates, particularly on high personal income earners and corporations. This more competitive context represents a challenge for euro area countries and highlights the importance of carefully assessing the efficiency and quality of taxation and public expenditure.

5 Gaddy, C. G. and Gale, W. G. (2005), "Demythologizing the Russian flat tax", *Tax Notes International*, 983-988; Ivanova, A., Keen, M. and Klemm, A. (Eds.) (2005), "The Russian flat tax reform", IMF Working Paper WP/05/16.

6 World Bank (2005), "The Quest for Equitable Growth in the Slovak Republic. Earning Your Way Out of Poverty: Assessing the Distributional Effects of Recent Slovak Reforms of the Tax and Benefit Systems", World Bank Living Standards Assessment: Policy Note 2, Report No. 32433-SK.