



The case for flat taxes

Pioneered in eastern Europe, flat tax systems seem to work because they are simple

AN ARTFUL taxman, according to Jean-Baptiste Colbert, treasurer to Louis XIV, so plucks the goose as to obtain the most feathers for the least hissing. Such arts are lost in America. As the April 15th deadline for filing tax returns falls due, the hissing is as audible as ever. But Americans are not alone. New Zealand's tax code instils "anger, frustration, confusion and alienation" in the islands' businessmen, according to a 2001 report to ministers. Adam Smith spoke for many when he bemoaned the "unnecessary trouble, vexation, and oppression" the people suffer at the hands of the tax-gatherers.

The White House claims to be listening. Shortly after his election victory, President George Bush set up a panel to advise him on how to reform the tax system. A report is expected this summer. Judging by the remit he has given them, Mr Bush wants to iron out some of the kinks in the tax code that distort saving and deter work, while retaining tax breaks for charity and homeownership. But he also wants to simplify the tax code for simplicity's sake.

The Americans are talking about it. Meanwhile in Europe, east of Vienna and as far afield as Russia and Georgia, they are actually doing it. In 1994, Estonia became

the first country in Europe to introduce a so-called "flat tax", replacing three tax rates on personal income, and another on corporate profits, with one uniform rate of 26%. Simplicity itself. At the stroke of a pen, this tiny Baltic nation transformed itself from backwater to bellwether, emulated by its neighbours and envied by conservatives in America who long to flatten their own country's taxes.

Latvia and Lithuania, Estonia's Baltic neighbours, promptly followed its example. In 2001, Russia too moved to a flat tax on personal income. Three years later, Slovakia imposed a uniform 19% rate on personal and corporate income, and set the same rate for its value-added tax (VAT) too, for the sake of symmetry rather than economic logic, it seems. In Poland, Civic Platform, a centre-right opposition party, wants to mirror Slovakia, only at the lower rate of 15%. In all, eight countries have now followed Estonia (see table on next page).

Might America do the same? The tax system there has been debated for years. William Simon, America's treasury secretary under President Richard Nixon, wanted a system that looked "like someone designed it on purpose". But the bewildering bulk and complexity of a mod-

ern tax code is not only the result of poor or malicious design.

Fairness is the chief reason why most countries have imposed multiple rates of tax. In Canada, Australia and the European Union, for example, staple foods, but not restaurant meals, are exempted from value-added tax. This is deemed fair because the poor spend a greater share of their income on unprepared food. It can lead to nonsense, however. Jeffrey Owens and Stuart Hamilton of the OECD point out that hot roast chicken is taxed, but cold roast chicken is not. "Does anyone expect tax administrators and business owners to have thermometers on hand when they do their tax calculations?" they ask, only half in jest.

In Luxembourg tax collectors work with no fewer than 17 different tax brackets, to ensure rich Luxembourgers pay a greater proportion of their income than their slightly less rich countrymen. The international trend, however, is away from such pointillism towards broader brushwork. Between 2000 and 2003, the OECD reports, seven of its members (including Luxembourg) cut the number of brackets, although Canada, Portugal and America all added one.

Fewer brackets are simpler to administer, but one bracket is simplest of all. Under a pure flat tax, the taxman takes the same cut from the last dollar you earn that he took from the first. The appeal to high earners is obvious. But the administrative elegance of such a system is not so immediately apparent. Because every dollar is taxed at the same rate, it does not matter to the tax collector how many dollars are go-▶▶

How simple can it be?

Flat tax rates on personal income, %

Country	Rate	Year introduced
Estonia	26	1994
Lithuania	33	1994
Latvia	25	1995
Russia	13	2001
Serbia	14	2003
Ukraine	13	2004
Slovakia	19	2004
Georgia	12	2005
Romania	16	2005

ing to whom. Thus, in principle, the taxman could simply withhold 20% of a company's payroll, without needing to know who was paid what. Add a second rate of tax, however, or a personal exemption, and the tax collector must find out how much money is going into each pay packet before he can be sure of collecting the right amount from the right person. In America, for example, the tax collector needs to tax the wage packets of 130m or more employees, rather than simply taxing the payrolls of 8m or so enterprises.

How much fairness is gained for all this extra complexity? Surprisingly little, suggest Messrs Owens and Hamilton. In New Zealand, for example, only the richest tenth of households pay much more under the country's progressive income tax than they would under a 25% flat tax (see chart on page 71). Most of the redistribution in New Zealand is carried out on the other side of the government's ledger, by spending more money on poor people.

To the layman, a flat tax simply means a single rate of income tax. But the connoisseur of the flat tax can distinguish several different varieties. In America the flat tax is associated with a proposal advanced by Robert Hall and Alvin Rabushka, two economists at the Hoover Institution. Their tax, which falls on businesses and households, and allows a personal exemption, is designed not to tax saving. It thus resembles a consumption tax, such as VAT, more than a traditional income tax, which is typically also levied on returns to saving, such as interest and dividends. Slovakia, which taxes profits firms make, but not the dividends they distribute, perhaps comes closest to this model.

Flat, not low

Nor are flat taxes synonymous with low taxes. Certainly, most countries have cut their tax rates as they have flattened them. In 1994, Ukraine's top rate reached the stratospheric level of 90%, before descending, in stages, to its current single rate of 13%. But Lithuania's 33% flat rate is too high for some American conservatives.

Nevertheless, Lithuania's example might make flat taxes more palatable to the

social democrats of western Europe. Miguel Sebastián, an economic advisor to Spain's socialist government, has advocated (largely in vain to date) a flat tax of 30% on Spanish incomes. Last year, a panel of academics set up by Germany's finance ministry also proposed a 30% flat tax on all personal and corporate income.

Flat taxes differ in scope as well as height. Since 2001, Russia has imposed a single 13% tax rate on all personal income. But it has a different rate for corporate profits: 35% at the time of its 2001 reform. Slovakia's flat tax, by contrast, covers both personal income and corporate income, as well as VAT. Taxing pay packets and profits at the same rate discourages an obvious form of "tax arbitrage". For example, it was reportedly quite common for Slovak salaried employees to declare themselves self-employed, while continuing to work for the same company much as before. Their wages would then be taxed as profits. Not only that, their lunch could be counted as a business expense.

Unfortunately, Slovakia's fiscal purism is somewhat adulterated by a heavy payroll tax. The social-security contributions of employees and employers combined amounted to almost half of labour income in 2004. Since this burden falls on earnings from work, not from capital, it restores the incentive for Slovaks to convert one into the other, by declaring themselves self-employed subcontractors. It may also drive some economic activity into the shadows, where the social-security agency cannot find it.

At the time of its reform, Estonia also taxed labour and capital at the same rate. After 2000, however, it chose not to tax profits at all until they are distributed to shareholders as dividends. This gives companies an incentive to retain their earnings and reinvest them. Indeed, very little of the burden of taxation in Estonia falls on corporations directly: corporate taxes accounted for only 3.6% of total tax revenues in 2003.

Estonia's economy has grown impres- ▶▶

Tax compliance in America

The burden of complexity

The costs of complying with America's tax rules

AS ADAM Smith noted, taxes are often much more burdensome to the people than they are beneficial to the sovereign. In America, some have tried to estimate exactly how much more burdensome. The Treasury estimates the total costs of complying with the income tax at about \$125 billion a year.

The Internal Revenue Service (IRS) itself is quite lean. Its staff numbers actually fell by 15% between 1993 and 2001. For every \$100 it raises in net tax revenue, the IRS costs just 52 cents; its French counterpart costs \$1.44, according to the OECD. Adam Smith bemoaned the "frequent visits and the odious examination of the tax-gatherers," but the chances of being audited by the IRS are much lower than most Americans assume. Jeffrey Owens and Stuart Hamilton, of the OECD, reckon the IRS has only enough auditors to check the books of each American business for one day every ten or 11 years.

The miserly budget of the IRS is, of course, only one part of the total cost of complying with America's tax code. According to a somewhat dated study by Marsha Blumenthal and Joel Slemrod, two respected tax scholars, it takes the average American taxpayer 27.4 hours to file his taxes. But the burden varies greatly. Just under 30% of filers spend less than five hours. These taxpayers perhaps have little cause to hiss.

Besides, all such estimates have to be taken with several grains of salt. Most of official estimates are based on a survey that is almost 20 years old. Taxpayers were asked how many hours they spent keeping records, deciphering the tax code and filing their 1983 tax forms. But their answers may have little relevance today. The task of complying with the tax code is now easier (thanks to computers) but also more difficult, because of the code's seemingly organic annual growth in length and obscurity.

The common proxy for this extra difficulty is the number of new words added to the code since the survey was taken (about 500,000). But extra words do not necessarily mean extra complexity. When the Australian government tried to translate its tax rules into plain English it discovered that five lines of code could decompress into as many as five pages of comprehensible prose.

In part, "trouble, vexation and oppression" are the price Americans pay for the tax exemptions, deductions and concessions they cherish so much. As well as raising revenue, America's tax code is charged with inspiring charitable giving, promoting homeownership, defending marriage and delivering pork to the favoured constituencies of ambitious congressmen. If America's tax system asks a lot of its citizens, it may be because they ask a lot of it.

sively since its 1994 reform. Growth reached double digits in 1997, and has since settled at around 6% annually, after a slump at the turn of the century. Repealing its high tax rate on the rich did not erode the country's tax base as some might have feared. In 1993, general government revenues were 39.4% of GDP; in 2002, they were 39.6%. Estonia now plans to cut its flat tax from 26% to 20% by 2007.

But how much do Estonia's robust revenues owe to its flat income tax? Perhaps less than is frequently advertised. In 1993, the year before its reform, Estonia's multiple personal income taxes raised revenues amounting to 8.2% of GDP. In 2002, its flat income tax raised revenues worth just 7.2%. Indeed, the flat income tax that generated so much excitement abroad seems to be carrying less weight than Estonia's old-fashioned VAT, which raised 9.4% of GDP in revenues in 2002.

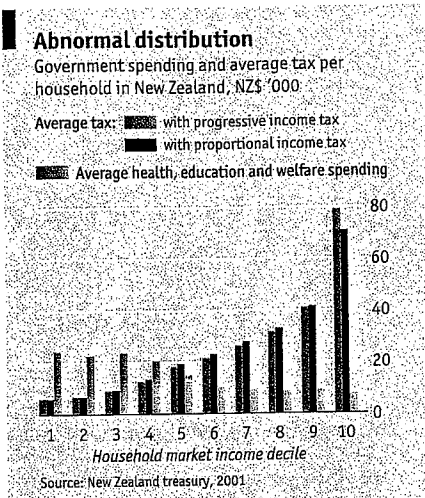
VAT is, of course, the flattest tax of all. It levies a uniform rate on the goods you buy, taking a constant cut of your money when it is spent as opposed to when it is earned. Estonia's VAT is also quite broad, leaving relatively few things out (hydropower and windpower were two curious exceptions). The same point could be made about Slovakia. At 19%, it has a relatively low rate of income and corporate taxes, but one of the highest rates of VAT in Europe. It may be this high rate of VAT, not the flattening of its other taxes, that sustains the government's revenues in the future.

Flat taxes on the steppes

The most remarkable turnaround in government revenues was recorded in Russia. Prior to its 2001 tax overhaul, the federal government's tax-raising powers were rapidly deserting it. Clifford Gaddy and William Gale of the Brookings Institution report that tax arrears amounted to 34% of collections in 1997. By 1998, federal revenues had fallen to just 12.4% of GDP, leaving the government unable to pay its creditors. Investigators appointed by the president revealed that Russia's biggest enterprises ignored 29% of their taxes and paid another 63% in kind, with goods and services the government might or might not want. In lieu of \$80,000 in taxes, one company reportedly offered the government ten tonnes of toxic chemicals.

On January 1st 2001, Russia flattened and broadened its personal income taxes, collapsing 12%, 20% and 30% bands into a single, uniform 13% rate. The state also withheld taxes at source, identified taxpayers by number, and audited suspected tax-dodgers. Messrs Gaddy and Gale note that no tax system could hope to bring in much revenue without these rudimentary instruments of tax enforcement.

How did revenues respond? A year after the reform, the personal income tax was raising almost 26% more revenue in



real terms. Some of this was due to the rebound in the economy: real wages grew by 12% that year, and the take from all taxes, flat or otherwise, consequently improved. But the surge of rubles encouraged by the flat tax was more sustained.

A careful study by two IMF economists, Anna Ivanova and Michael Keen, together with Alexander Klemm, of the Institute of Fiscal Studies in London, tries to unearth the causes of this pleasant fiscal surprise. They find little evidence that Russians, freed from the yoke of progressive taxation, suddenly started working much harder. This is perhaps not surprising, as Russia's reform actually raised personal income taxes for the many households that previously fell into the 12% bracket.

They did discover a conspicuous increase in compliance with the tax authorities, however. In the year before the flat tax, Russians in the two higher tax brackets reported only 52% of their income to the taxman. In 2001, after falling into the new, all-encompassing 13% bracket, these same households reported 68%.

Many advocates of the flat tax, particularly in America, argue that it sharpens the

incentive to work. A progressive income tax, they claim, deters extra effort from society's best-paid (and therefore most productive) members. Russia's experience, however, suggests that the principal virtue of the flat tax is its simplicity. The government's revenues did not surge because Russians suddenly squared their shoulders and straightened their backs. Rather, Russia's tax system became easier to administer and easier to comply with.

America is not Russia. It has a functioning tax system, albeit a clumsy one, so has something to lose from uprooting its tax system and starting again. But the potential gains are not negligible. In a typical year, the IRS estimates that for every dollar it collects, another 19 or 20 cents is owed, but not paid. This shortfall amounted to between \$312 billion and \$353 billion in 2001. Small businesses fail to report about 30% of their earnings. Babysitters and gardeners fail to report 80%, says the IRS.

In part, the tax system is burdensome because people dodge it. Every loophole that is exploited must be plugged. Every blurry line that is crossed must be sharpened. But Messrs Owens and Hamilton worry that the tax-codifiers and the tax-dodgers are locked in a mutually destructive "arms race". The code is made more complex, because of tax wheezes. More people then seek to avoid taxes. The best way to fight tax avoidance, then, is with simplicity.

As every American knows, their country was founded in the wake of a tax revolt. What most forget is that the so-called "Boston tea party", a raid on the cargo of British ships in Boston harbour, was not provoked by a tax hike. The British had in fact scrapped duties on tea, cutting out commercial middlemen. It is not going too far, then, to suggest that the American Revolution was provoked by a simplifying tax reform. Mr Bush must hope his own reforms, should they ever see the light of day, will encounter less stiff resistance. ■

