



## **PERSPECTIVES OF THE FLAT RATE TAX WITHIN THE CONTEXT OF THE ECONOMIC CRISIS**

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### **Rezumat**

În 1981, în Wall Street Journal, Robert Hall și Alvin Rabushka formulau paternalist argumentul contemporan în favoarea unei „flat tax”. Avantajul cotei unice ar fi dat, în principal, de simplitatea sistemului fiscal. Apoi, un nivel de impozitare mai scăzut va stimula economisirea, investițiile și spiritul întreprinzător, care vor susține progresul economic general.

Cota unică este considerată de către inițiatorii ei a fi o taxă pe consum, pentru că investițiile noi sunt exceptate din baza de impozitare. Astfel, cota unică trebuia să stimuleze economia pe partea de ofertă. Rezultatele obținute arată faptul că în țările unde a fost introdusă cota unică această condiție nu s-a îndeplinit, iar investițiile noi nu au fost exceptate de la impozitare. Dimpotrivă, și cazul României este relevant, cota unică a stimulat economia pe partea de cerere, ducând la creșterea accelerată a consumului și la adâncirea deficitului de cont curent.

### **Abstract**

In 1981, Robert Hall and Alvin Rabushka were formulating in the Wall Street Journal, in a paternalist manner, the contemporary argument in favour of the flat rate tax. The main advantage of the flat tax is the simplicity of the fiscal system. Then, a lower taxation will stimulate saving, the investments and the entrepreneurial spirit, which will support the general economic progress.

The flat tax is regarded by its initiators a tax on consumption, because the new investments are exempted from taxation. Thus, the flat tax

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should stimulate the economy on the offer side. The results show that the countries where the flat tax has been introduced didn't accomplish this condition, and the new investments were not exempt from taxation. On the contrary, and the case of Romania is relevant, the flat tax stimulated the economy on the demand side, which increased very fast consumption and deepened the current account deficit.

**Keywords:** flat tax, progressive taxation, international comparisons, economic agent, state, economic crisis

**Jel classification:** E26, H25, H26, H32, O11, O23

### **1. Theoretical aspects. Evaluation of the flat tax impact**

The introduction of the flat tax is a proposal of two American economists, Hall and Rabushka, formulated in the early 80s, which developed an original idea of Milton Friedman. They wanted to replace the progressive taxation, affected by flaws and deductions, by a single tax rate for all incomes, applied just one time – the flat rate tax. However, the flat tax “is progressive where it matters the most for the poor”, meaning that it is accompanied by an exemption for the incomes below a specific level. Actually, it means there are two kinds of taxes: 0, for all incomes up to a specific level, and another rate (the level proposed for the USA was 22,500 USD per year) for all the other incomes. The exemption of the poorest population probably is a compromise in order to accept what the authors admit as being “an extraordinary advantage for the economic elite” (They proposed a level of 19%). In a neutral scenario concerning the impact on the budget revenue, there are winners and there are losers when the flat tax is introduced: if the poorest are exempt, and the wealthiest ones are certainly advantaged, the fiscal burden falls on the middle class.

The flat tax is regarded as a tax on consumption because the new investments are exempted from taxation – at least according to the proposal of Hall and Rabushka. From this perspective, a tax on consumption should lead to a lower consumption, thus creating “stimuli to save and invest”. The flat tax, as initially proposed, should have stimulated the economic on the offer side. The results show that the countries where the flat tax has been introduced didn't accomplish this condition, and the new investments were not exempt from taxation.

Although the success of the flat tax was not demonstrated conclusively in terms of higher revenues to the budget, some countries continue to use it. Murphy (2006) offers a plausible explanation: the flat tax is a political goal, not a fiscal policy. Keen, Kim and Varsano (2006) also think that the main reason for the flat tax comes from the area of the political marketing, as a signal towards the exterior, for some fundamental changes of system. There are frequent cases when the flat tax followed a radical change of government, such as in Russia, Georgia, Ukraine or Romania.

If the flat tax was a rule for all the industrialized countries during the first half on the 19<sup>th</sup> century, the first strong demands for a “strongly progressive and gradual taxation system” appeared in Karl Marx’s 1848 communist manifest. Afterwards, the capitalist states adopted this system. Even if, worldwide, the taxpayers spend each year about 8 billion hour filling the income declarations, no major western economy turned back, so far, to the old flat tax system.

The recent trends from the eastern countries show a preference for the flat tax. This started with Estonia (1991), followed by Latvia (1994), Lithuania (1994), Russia (2001), Serbia (2003), Ukraine (2003), Slovakia (2003), Georgia (2004), Romania (2005) and Bulgaria (2007), as shwn in Figure 1. The flat tax is also stipulated in the governance program of the Czech authorities.

Country	Flat rate tax, %
Latvia	26%
Slovenia	20%
Slovakia	19%
Romania	16%
Czechia	15%
Bulgaria	10%

The efficiency of a specific taxation system was object of dispute between researchers. The European Commission considers that there is no need for a transboundary harmonization of taxation in the member states. On condition that they observe the community regulations, the member states are free to choose the taxation system they consider to fit them best.

### **The impact of the flat tax on the real economy**

The flat tax, introduced over the recent years in several countries from the region, shows it is sustainable. The analysts consider that the system by which everybody pays the same tax rate eliminates both the complex bureaucracy, and stimulates the people to work harder and save their earnings. The main reason why Romania adopted this system was to bring the informal work into light.

Accompanied by more frequent control of the economic police and by increased punishments for tax evasion, the results were positive, little less for Hungary which analyses the increase of the taxation rate to 16% in 2011. The states which use lower flat taxes compensate by higher taxation on consumption.

The impact of the flat tax can be measured with several indicators.

1. The indicators *stimulating the decrease of the informal work* are:

- Evolution of the number of labour contracts registered with the Territorial Labour Inspectorate after the introduction of the flat tax.
- Trends of the informal work, as observed after the inspections of the Territorial Labour Inspectorate

2. The indicators *evaluating the efficiency of tax collection* (simplified procedures to collect, monitor and cash the taxes, lower tax evasion and informal economy) are:

- Increase, stagnation or decrease of the estimated income (taxation basis) declared for a specific year;
- Increase, stagnation or decrease of the number of registered taxpayers (income declaration);
- Increase, decrease of the fiscal yield (voluntary collection of the due taxes, or official checking);
- Opinion of the financial administration employees on the new system of tax collection, monitoring and cashing, compared to the old one.

An important problem relates to the way in which the flat tax favours investments. Theoretically, the lower taxes for the people with high income should favour the formation of capitals good for investments. In practice, the surplus of income might be directed towards the luxury consumption, as a negative feed-back, diminishing the productive investments. The consumption of the economic surplus should be as much equitable as it can be, but it is equally important the way in which these incomes return to the economy as investments which generate economic development. We arrive thus

at an area where there is need for additional regulation – taxation of the luxury goods – of the expensive real estates and cars, etc.

Thus, the main target of the taxation system reform for the natural persons must be the optimization of revenue collection with the level of state expenditure, and the optimization of the actual taxation system by decreasing the highest taxation rates, particularly for the natural persons, by allowing less fiscal facilities etc.

Within this context, the authorities should pursue four objectives.

- Preserve the balance of the revenues to the budget. The authorities must monitor not just the absolute value cashed from the income tax, but also their proportion, compared to the amounts cashed from social contributions.

- Preserve the balance between social equity and efficiency of the fiscal system. Granting fiscal facilities to some economic sectors or groups of persons will require a complex system, as well as higher tax rates than in a system with no fiscal deductions, but with a broad taxation basis.

- Decrease the complexity of the fiscal system. Theoretically, the purpose of the fiscal policy is to cash incomes at costs as low as possible, which prompts the use of a flat tax for the incomes, with no deductions or fiscal facilities. However, there is a great problem with the determination of the taxation basis and with the administration of the costs incurred with taxpayer conformation.

- Cope with the external pressures, under the conditions in which most developed countries want to cut the taxes, but at the same time they want to have an efficient fiscal system, which means getting revenues for the social sector (pensions, health, education).

At the same time, through the fiscal deductions, the state will contribute to the actual accomplishment of some fundamental citizen rights such as the right to education and the right to health care, supporting indirectly part of the expenditure for schooling and health care treatments incurred by the citizens.

## **2. Fiscal reforms of the countries which adopted the flat tax**

All the states which introduced the flat tax have a good economic situation, particularly by enlarging the taxation basis (real income statement), and by increasing the taxpayer number (less informal work).

The purpose of the progressive taxation of the natural persons incomes is not economic, rather social. At the same time, in terms of

economy, this system supports the emergence and development of tax evasion and informal work.

**Estonia** is the first country which adopted, in 1994, the flat rate tax of 26% for the incomes of the natural persons. There was a basic personal deduction, which was increased subsequently. The flat tax is part of a coherent plan aiming to cut the taxation level as follows: the profits reinvested in the company, therefore, not distributed, are exempt from taxation. Although the measure is not agreed by the European Union because of the high taxation from the member states, Estonia maintained this provision and will adapt it according to the acting European provisions and norms.

**Lithuania** followed largely the pattern of Estonia, but only assumed part of its commitments. Thus, also in 1994, Lithuania adopted the flat tax, but at the highest level, 33%, in relation with the countries which adopted it subsequently. As safety measure, the basic personal deduction was increased substantially in order to protect the taxpayers with low incomes. Meanwhile, the value of the flat tax was reduced to 27% as of July 2007, and to 24%, as of 2008.

**Latvia** adopted the flat tax in 1997, at the level of 25%, similar to that from Lithuania, when it adopted the flat tax for the first time. Latvia followed a strategy of fiscal competition which led to a lower rate of capital taxation, which is now 15%.

**Russia** adopted the flat tax in 2001, at the level of 13%. The social contributions are regressive, from 35.6%, to 5%, targeting the control and reduction of tax evasion, while the personal deduction decreased function of the income. The tax on dividends increased from 15% to 35% and the tax on profit reached 35%, from a previous level of 30%.

**Slovakia** adopted the flat tax in 2004, at the level of 19% for profit, VAT and the income of the natural persons, being followed by **Georgia**, in 2005, which introduced the 12% flat tax for the income of the natural persons. The tax on profit remained at 20%, while the social contributions were decreased from 33%, to 20%.

As of January 1<sup>st</sup>, 2005, **Romania** adopted the flat tax at the level of 16%, representing the tax on the global income, on the bank interest, on the gains from stock exchange transactions, for the gains from real estate transactions of the natural and legal persons. The tax on profit was decreased to 16% from 25%. The fiscal reforms which started in Romania were part of a wider process of consolidation of the market economy mechanisms, by simplifying the administrative procedures.

The introduction of the flat tax aimed, on the one hand, to decrease the taxation level for the enterprises. After a period in which inflation peaked, most of the Romanian companies were decapitalized, so that the adoption of the 16% flat tax stimulated the revival of companies. On the other hand, the flat tax aims to increase the profit of the companies, a recapitalisation or a better capitalisation of them. In a wider approach, the revival of the companies is correlated positively with job creation and with the economic growth.

The most important influence of the flat tax, however, is on the untaxed, informal economy. The official statistics showed that in 2005 we were on a rising trend concerning the share of the informal economy. The introduction of the flat tax curbed this trend and taxed the incomes, aiming thus to keep under control the informal economy in Romania.

In 2007, **Macedonia** and **Bulgaria** adopted the flat tax for the incomes of the natural persons at the level of 12%, and 10%, respectively. In **Bulgaria**, the flat tax became operational in 2008.

**Albania** and **Czechia** introduced the 10% and 15% flat tax in 2001. The Czech Premier Mirek Topolanek proposed a legislative package which stipulated the reduction of the flat tax to 12.5% in 2009. The tax on income in the corporatist sector was decreased from 24% to 21%.

However, the European Commission doesn't consider as prudent and necessary, in this economic configuration of the member states, the uniformization of their taxation systems. The member states are free to chose the taxation system which answers best their specific needs and difficulties, as long as they implement the community regulations too.

### **3. Arguments for and against the flat tax**

The short and medium-term consequences of adopting the flat tax refer to the increased competition between the European states, manifested by the introduction of a lower flat tax than in other countries, whose finality is the continuous refining of the economic mechanisms of a specific state, in order to maintain a competitive standard on the market.

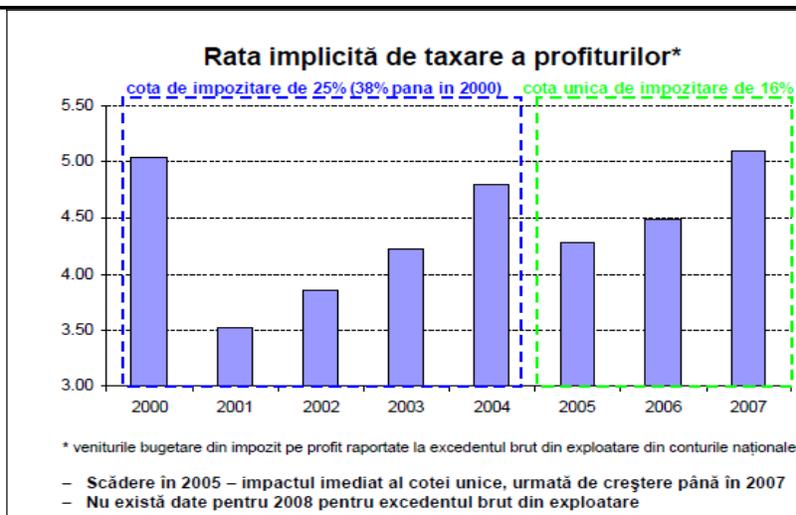
The flat tax had its basic role to stimulate the economy on the offer side. The flat tax didn't just simplify the fiscal administration, but also favoured the accumulation of capital and allowed work efficiency to

increase. Even under the conditions of the financial crisis, no country which had adopted the flat tax, returned to the progressive system.

Leaving the flat tax system by the Central and East European countries would create a significant competitive disadvantage, mistake which Romania must avoid, much so as the efforts in the region focus on:

- the decrease of the flat rate tax,
- individual administration of the additional income which is directed towards investments, saving and consumption by the taxpayers and not by the politicians/state,
- economic competitiveness due to a higher attractiveness for the foreign investments.

The countries using the flat tax generally have a lower level of the budgetary revenues in the GDP than the countries using the progressive taxation. For a more detailed comparison we have: France, Germany of the United Kingdom, as reference EU economies, on the one hand, and several new member states, Czechia, Poland and Hungary, on the other hand. Hungary and the United Kingdom have two taxation rates for the income, Poland has three, same as Germany, while France has five taxation rates. The largest taxation rate exceeds 40% for a specific multiple of the average wage (almost 3 for Poland and France and almost 6 for Germany). Czechia is the exception, with flat tax, similar to Romania. However, the total taxation level is higher than in Poland or the United Kingdom.



Romania has 16% tax on the income and profit. In Czechia, one of the most developed economies in the region, the income tax is 15% and the profit tax is 19%. Bulgaria has changed its fiscal system in 2008, among the last countries to do so. Over the past 15 years, many states, mainly from Eastern Europe, had decided in favour of the flat tax.

**Advantages of the flat tax:** promote equality, reduce the fiscal burden for the companies and persons and, most important, increase the revenue to the state, under the conditions in which an increasing number of companies tend to leave the informal economy. Apparently, only the government will have less revenue. However, there are several benefits, among which the fact that the companies are thus stimulated to pay their taxes fairly and in time. It was also noticed that a system of progressive taxation fuels consumption, while the flat tax encourages the people to save and to invest.

According to a study by the National Centre for Analysis, “Economic effects of the flat tax”, in the situation of a system of progressive taxation, the investments in industry will not go towards the most competitive and attractive branches. Due to the subsidies and differential treatment of the industries, it is more worthy to invest in sectors with modest rates of growth and with small profits. A flat rate tax system favours equally all sectors.

The individuals too, are encouraged to work harder, earn more, in the situation of a flat tax. The progressive tax is perceived as a punishment for the people of success. The flat tax encourages both the expenditure and the start-ups, according to the same study.

**Advantages of the progressive tax:** it fuels consumption, helps the people on low incomes, favours the small and middle companies.

#### **4. Why is rejected the flat tax of 10% (12%)?**

A flat tax lower than 16% would decrease significantly the revenues to the budget, but it would encourage the investors, fiscal attractiveness being the key to the economic revival.

Thus:

- A lower flat tax would generate immediate losses in the revenues to the budget (1.8% of the GDP).

- A political decision in favour of a fiscal shock by decreasing the flat tax is difficult before discussing about resizing the social insurance contributions and the value added tax, which are now among the highest levels in EU, or before the modification of the unfair minimal tax.

- The Romanian people has not yet participated in a serious, ample debate on the taxation rate (except the option for the flat tax in 2004 and 2008), on the public services and social obligations to be paid from the state budget. This debate must start from the reality that a country which wants to have a lower taxation rates than other countries, will have to find a fair balance between financing the social obligations from the budget and the contributions of the taxpayers through taxes, dues and other contributions to the state.

- In 2011, the budget deficit must be reduced below 5% of the GDP; this means additional adjustments of the public expenditure and the increase of the revenues to the state budget. The decrease of the flat tax would double this effort in the next year, with new adjustments to the expenditure which amounts to 3.6% of the GDP.

**What economies could be done and what public revenue could increase in equivalent amounts to the current fiscal gaps and short-term losses of revenues to the budget, if the flat tax is to be reduced, and how?**

- Additional collection of public revenue of at least 0.45 of the GDP, by decreasing the informal work, on the short-term. The informal work

represents almost half of the informal economy. Therefore, a realistic public target may be a 20% decrease of the informal work, on the short-term.

- Economies in the public expenditure with the pensions, amounting to about 0.5% of the GDP, by curbing the early retirement, the retirement due to disease or infirmities, to which we can add the positive indirect effects of their reinsertion on the labour market.

- The improved collection rates from the measurable and observable taxation basis leads to a 2.6% (of the GDP) cumulated surplus of revenue, resulting from the contribution of VAT (+1.5% of the GDP), pensions (0.6% of the GDP), health (0.5% of the GDP) and unemployment (0.03% of the GDP).

### **Some conclusions**

The introduction of the flat tax in Romania generated several effects:

- About 150,000 jobs were taken out from the informal (untaxed) economy;

- Foreign investments were attracted due to the competitiveness of the taxation rate; this resulted in job creation corroborated with the limitation of the social contribution paid by the employers and by the employees;

- It produced a surplus in taxpayer incomes, surplus which could be directed towards investments, saving and consumption;

- It deterred the behaviour of seeking tax evasion solutions;

- It deterred the fiscal immigration of the Romanian taxpayers and prompted the specialists to remain in the country;

- Corroborated with the measures to support the foreign investments, the flat tax will attract the citizens of other European states to settle their fiscal residence in Romania and to pay taxes for their global income in Romania, so as to take advantage of a favourable taxation system;

- It simplified the system of fiscal administration both from the perspective of the taxpayer, and from the perspective of the fiscal authorities, system which is considered to be bureaucratic, thus reducing the costs of income tax forms processing by giving up to globalization and regularization on the income from wages.

The benefits of the flat tax were often subordinated to the idea that the state will take "less from more", namely by increasing the taxation basis.

For the capitalist development of Romania, the state must definitely withdraw from the economic stage. More resources should remain to the private sector and to the rightful owners, which to really «unleash» the accumulation of capital and the investments, the free enterprise and innovation. However, for this to happen, the state must not cash more, using a lower taxation rate, rather, it must cash less using a taxation rate as low as possible.

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