How Flat is the Flat Tax

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The tax system is one of the most reformed and most discussed system from the economic systems in any economy. As it comes to taxes everyone is an expert as we all pay them. The last decades are going under the influence of the flat tax. Numerous countries adopted the idea of the so called flat tax "revolution". This paper will make an outline on this revolution and its impact on the economic development in the countries implemented the flat tax. It will present the pros and cons for such change and does flat mean fair.

> *"I guess it's like trying to put through the flat tax, which is probably my favorite one of all.... if we did pass it, all of a sudden, what do you have? You have the whole tax system run by a little old lady on a home computer, doing the work of all these thousands of bureaucrats and accountants. Passing that would be amazing, wouldn't it?"*
> *--Clint Eastwood in an interview with the New York Daily News, November 19, 1997*

We all admire the act and director's work of Clint Eastwood but as Peter Principle states in every hierarchy, whether it is government or business, each one tends to rise to his level of incompetence. So let us leave Mr. Eastwood to do his marvelous pieces of art and leave the tax system at peace.

The taxation is a product of the state. Every deal can happen, with out the existence of taxes but the government mechanism cannot work with out tax revenues. Depending from the stage of the development and economic prosperity there are different taxes for gathering of those revenues. Low developed countries for example, rely mostly on the revenues from costumes and indirect taxes. This is due to the low employment rate and lack of developed industry. The courtiers with market economy direct their attention to the income taxes as basic revenue sores and lever for the development of the economy. No matter which taxes will be used, all of them are listed in a system which has to support the neutrality of the taxation that is no matter of the changes that the separate taxes suffer the revenue should be stabled and should not lead to general changes of the economic agents' behavior on the market.

The main goal of this paper is to show the place and role of the flat tax in the contemporary development of the tax systems in the emerging market economies (mainly in Bulgaria). This will be done by revealing the distortions created by the flat tax and the myths that the flat tax defenders are creating: a) the flat tax is fair; b) the flat tax will shrink the shadow economy; c) the flat tax will increase the revenue and will help the economic development.

HISTORICAL RETROSPECTIVE

Ever since the taxation was established every author has tried to find the most fair tax system and such distribution of the tax burden that will satisfy all the taxpayers. That is why every tax system in any country goes through changes pretty frequently. The changes are affecting changes of the tax base, replacement of one tax with another and changes in the tax rates. The latter are related with the progressiveness, proportion or repressiveness of the rates.

On December 10, 1981 Robert Hall and Alvin Rabushka has started their crusade on the flat tax issues. So 30 years later almost 27 states have transfer to the flat tax in their personal income taxation. Although jurisdictions such as Hong Kong, Jersey and Guernsey have operated successful flat tax system for decades, the modern flat tax "revolution" began with Estonia in 1994. Against the advice of Western economists, the newly independent country of Estonia enacted a flat tax effective January 1, 1994. It set the rate at 26 percent to balance its budget. It has since lowered the rate on several occasions, and the tax is scheduled to fall to 20 percent in 2009. Estonia has also abolished its corporate income tax, only imposing the same flat rate on distributed dividends. Table 1 shows the current club of flat tax nations. Most of the countries in this club are from the former socialist states.

TABLE 1
COUNTRIES WITH FLAT TAX RATES

Countries	*Personal flat tax rate %*	*Year introduced*
Estonia	22	1994
Latvia	25	1995
Lithuania	33	1995
Russia	13	2001
Serbia	14	2003
Ukraine	15	2004
Slovakia	19	2004
Georgia	12	2004
Romania	16	2005
Kyrgyzstan	10	2006
Kazakhstan	10	2006
Macedonia	12	2007
Mongolia	10	2007
Montenegro	15	2007
Albania	10	2007
Bulgaria	10	2008
Czech Republic	15	2008
Mauritius	15	2009
Iceland	36	2007
Hong Kong	16	1947
US States with flat tax rates		
Colorado	4.63	
Illinois	3	
Indiana	3.4	
Massachusetts	5.3	
Pennsylvania	3.07	
Rhode Island	5.5	
Utah	5.3	

Source: Author based on different publications.

Almost all of the emerging market economies has developed their tax system and elaborated their tax structures after the experience of the existing market tax systems in the Western countries. The lack of cultivated tax culture was the main reason that most of the economic agents and individual tax payers went into the shadow economy.

Under state planning, it was physical output that was the subject of policy-making. The financing of government policy through taxation, and the impact on economic incentives through wages and prices received little, if any, attention. Taxes were implicit and their functions were clearly related with their fiscal function. Taxes were not used as a way of regulating the economic activity, since in the planned economy there was no such necessity. Taxes were a measure for suppressing people's income, since even their fiscal function was lowered. Most of government expenditures were met by extending subsidies and soft budget financing. Taxation was dealt with as deductions and cuts from "marginal labor" or "manufacturing product". The definition of income and profit were not in use. The socialist social security system with its "free" medical, educational and social services was heavily subsidized by the state budget.[1]

The original idea of Hall and Rabushka has no practical realization-none of the countries applies the flat tax as it was proposed. The tax technical which is hidden behind the so called "flat tax" is something different- this is an income tax with flat rate and none taxable minimum. Many of the countries have replaced the complex progression with the Bentham progression. The tax base on the whole is the income not the consumption. The integrated flat tax proposed by Hall and Rabushka is a consumption and not income tax- something similar to the existing in the European Union (EU) value edit tax (VAT).

THE FLAT TAX CHARACTERISTICS

In the professional literature there are two definitions for a flat tax – flat sum tax, that has no correlation with any other quantative value, such as income, known also as presumptive taxation and flat rate tax, that is synonymous to a proportional taxation, used basically in corporate income taxation and consumption taxation.

The idea of Hall and Rabushka is a symbiosis of the latter two. They are writing about simplifying the federal income tax system mainly relaying on lowering the rates and abolishing all the deductions and this will lead to more revenue and stable economic growth.

The flat tax of Hall and Rabushka is a system of two taxes – wage tax and business tax, but neither wage tax is similar to personal income tax, nor is business tax equal to corporate income tax. The wage income (and other earned income) after certain nontaxable minimum are taxed with a single flat rate. The combination of Flat tax rate – Non taxable minimum creates certain progressiveness of the taxation process – the tax liability grows more rapidly than the tax base and the average tax rate is not proportional. This technique for achieving progression is created by the English utilitarian philosopher and social reformer Jeremy Bentham (1748 – 1832) and is known as Bentham's progression.

The corporate income is decreased by the investment spending and is taxed with business tax with the same rate. So the so called "integrated flat tax" is just consumption tax since in macroeconomic aspect when the investments (savings) are taken out the rest is the income that is consumed. The VAT is neutral and does not tax savings and investments.

In 1996 under the advice of the World Bank, more like a social experiment Bulgaria introduced presumptive taxation. The so called patent tax was the first flat tax touch at the Bulgarian tax system.

PATENT TAX (PRESUMPTIVE TAXATION)

Presumptive or imputed tax is generally a proxy for standard tax, which is applied when the tax base is too small or hard to verify, due to limited administrative resources, or improper accounting practices. According to a definition by Ahmed and Stern (1991), "The term presumptive taxation covers a number of procedures under which the 'desired' base for taxation (direct or indirect) is not itself measured, but is inferred from some simple indicators which are more easily measured than the base itself." For instance, in its most common application as a proxy for income tax, tax liability is based on the presumed capacity to earn income, measured through indirect indicators, rather than on actual income. In this context, a presumptive tax is largely a tool that addresses administrative inefficiency (i.e. high cost per unit of revenue). It may reflect low revenue capacity of the taxpayer or high propensity to evade taxes. This implies that presumptive taxation is best used to reach the hard to tax sectors of the economy, such as the small business, agriculture or service sectors, self employed, as well as sectors or cases, where compliance gaps are above the average.

Presumptive taxes are among the oldest taxes. Earliest forms date back to the very origins of taxation when assets were the major source of income.[2] In the 17th and 18th centuries, taxes were based on measures of wealth rather than income: size or value of land and other assets, including number of doors and windows as an indicator of the value of residence and the living standards. Last two centuries witnessed profound changes in earning patterns, with increasing share of income and wealth generated through supplying labor, capital and fixed assets through the factor markets in return for wages, interest, dividends and rents. The emergence of the "social state" in the 20th c. in turn raised the significance of equity considerations and drove the move to progressive taxation. In result, taxation evolved away from taxes based on measures of wealth towards taxes based on actual earnings in its various forms. On the other hand, equity objectives required globalization of income, i.e. taxing total income, rather than its separate components (the so called "scheduler" taxation). Furthermore, with the development of accounting, tax collection evolved towards system of self-assessment of liability and filing tax returns.

Making equal the patent for some activities in Sofia hardly puts all taxpayers on equal basis. The jewelry shop in the Gara Iskar suburb does not have the turnover of that in the centre of the city but when talking about car service stations we have the opposite trend.

According to the Corlett-Hague Rule, every thing that is close to the free time activities has to be taxed higher because the free time itself could not be taxed. But when talking about kids' free time activities, this is not all only about following the rules of the public finances. Anyway, all entertainment activities related to the free time of our kids were taxed over 50 percent higher.

A drastic increase of the patent tax will put a significant part of the economy's agents in the shadow economy and will decrease the well-being of the population as a whole because the possibility of transferring these taxes to the consumers could be easily realized with the use of the goods' and services' prices.

This type of flat tax works only for local governments and the recent changes in the Constitution and some of the tax laws in Bulgaria placed the patent tax on the right track. Of course there should be waited a certain amount of time in order to evaluate this change.

THE FLAT TAX AND THE ECONOMIC DEVELOPMENT

One of the basic issues with the introduction of the flat tax is that it boosts economic development. This is based on the idea that it doesn't tax investment (savings) done either by the taxpayer or the business. This has urged many of the low developed countries to rush into the flat tax system.

Every tax change requires two basic moments- tax philosophy, which is what are the goals of the change and where will that change lead us to, and second two leave enough time for the realization of the change before being evaluated. These two moments were lacking both in the development of the market oriented tax system and during the numerous changes in the transition period in most of the emerging market economies and especially is valid for Bulgaria. The lack of tax moral and the barbarian fiscalism were hampering the regulative functions of the tax systems. Table 2 shows the economic development of these countries.

TABLE 2
GDP GROWTH (%)

Regions and countries	Annual average growth 2001-2008	GDP in 2006 1989 =100
Central European Countries and the Baltics		
Czech republic	4,7	129
Estonia	8,8	145
Hungary	4,1	134
Latvia	8,7	113
Lithuania	7,8	106
Poland	3,6	158
Slovakia	5,3	137
Slovenia	3,8	139
Average weighted	4,2	142
Southeastern Europe		
Bulgaria	**5,3**	**100**
Croatia	4,8	105
Romania	6,1	113
Albania	5,7	144
Bosnia and Herzegovina	5,1	75
Macedonia	1,9	91
Monte negro	2,9	73
Serbia	4,8	64
The Commonwealth of Independent States (CIS) and Mongolia		
Russia	6,2	93
Armenia	12,4	126
Azerbaijan	16,0	121
Byelorussia	7,9	135
Georgia	7,7	53
Moldova	5,5	49
Ukraine	7,6	63
Kazakhstan	10,4	125
Kyrgyzstan	3,6	87
Mongolia	6,0	137
Tajikistan	9,1	79
Turkmen	14,9	177
Uzbekistan	5,7	137
Average weighted	6,9	94
Average for all reforming economies	5,6	105

Source: EBRD, Transition Report Update. May 2007, p. 64

Most of the countries although have rapid economic growth has not reached their pre changes level and they consider the flat tax as a sort of panacea for their inherited or accrued economic problems. The answer is very simple. All this countries have similar socio-economic structure. Common for all of them is that the ruling politico-economic elites are coming from the former party nomenclature in the communist parties. Although a lot has been done for the transformation of the political power in economic power, still the new officials and economic elites doesn't have stable economic base. The corruption is high, the criminal activity and racketeering is high and so paying a high taxes on their high income would be a suicidal for them.

Some of the authors are stating that higher marginal rates act as a deterrent to the kind of wealth creation that trickles down to working people in the form of more jobs. Again, this is not an issue because the higher marginal rates only apply to the higher levels of income; all taxpayers still pay exactly the same rates on equivalent layers of income. Moreover, this widely-believed fallacy simply fails to grasp the true nature of wealth (or job) creation which is based on the faulty view that if you give tax breaks to the rich, or otherwise put more money into the pockets of those who already have the most, that they will use it to create jobs. While it is primarily the wealthy who invest the capital needed to create more wealth (and jobs), jobs are not created just because people have money. If they just have money, and that's all, they'll just keep it or spend it on themselves, as they always have done in the past. Jobs are not created as acts of charity for working people that the wealthy elites don't even have personal acquaintance with. Jobs (and broad-based wealth) are created when those in a position to administer productive resources see a *demand* for goods to be produced. And if they see such a demand, they will generate the increased production -- create new jobs -- whether or not they have the money on hand -- even if they have to raise money by borrowing the necessary capital for financing. If the general public, which is made up far ore by working people than by the wealthy elite, does not have discretionary income to spend on products, the broad-based demand needed to stimulate wealth creation (and job creation) is inhibited. It has more to do with creating a broad base of demand than by making sure rich people have enough money. [3]

Lower tax rates for high income people in the emerging market economies will stimulate luxurious consumption. This will increase the import of luxurious goods and distort the balance of payments instead of stimulating economic development. It might help economic development of the countries that are producers of luxurious goods – like yachts, expensive jewelries, clothes and other items but hardly will help the economic development of the emerging market economies.

THE FLAT TAX IS FAIR?

The choice of a taxable unit is important for any tax system. There isn't tax system that treats equally all the members of the society. So fairness is more a category of "Alice in wonder world" than a part of the tax system. No one tries to put equilibrium between flat and fair. One of the presidential candidates Mike Huckabee speaks on his site about fair tax relating it to consumption taxation:

> "The Fair Tax will replace the Internal Revenue Code with a consumption tax, like the taxes on retail sales forty-five states and the District of Columbia have now. All of us will get a monthly rebate that will reimburse us for taxes on purchases up to the poverty line, so that we're not taxed on necessities. That means people below the poverty line won't be taxed at all. We'll be taxed on what we decide to buy, not what we happen to earn. We won't be taxed on what we choose to save or the interest those savings earn. The tax will apply only to new goods, so we can reduce our taxes further by buying a used car or computer.
>
> Our current progressive tax system penalizes us for working harder and becoming more successful. As we climb the ladder, the government lurks on each rung, hungry for a bigger bite out of our earnings. The Fair Tax is also progressive, but it doesn't punish the American dream of success, or the old-fashioned virtues of hard work and thrift, it rewards and encourages them. The Fair Tax isn't intended to raise any more or less money for the federal government to spend - it is revenue neutral.
>
> Expert analyses have shown that the Fair Tax lowers the lifetime tax burden of all of us: single or married; working or retired; rich, poor or middle class.

> The Fair Tax will instantly make American products 12 to 25% more competitive because the cost of those goods will no longer be inflated by corporate taxes, costs of tax compliance, and Social Security matching payments. When we buy products now, those taxes are built into the cost, so all of us pay corporate taxes indirectly on top of the personal taxes we pay directly. Compliance costs are just make-work with no real added value, yet they consume as much as 3% of our gross domestic product annually. These costs are an especially heavy burden on small businesses, which generate most of our jobs."[4]

Under graduated, progressive rates, all people are created equal, but not all dollars are created equal. Earnings of the working poor (not those on welfare) go almost entirely for survival expenses such as food, shelter and clothing. At that level, every dollar is critical; even a small difference causes tremendous changes in the quality of life. No one enjoys a dip in income, a loss of ten or twenty thousand dollars is often within the normal fluctuation of a wealthy investor's investment portfolio, whereas that amount would be disastrous to the middle-class worker that has only salary income. This principle is most obvious at the extremes: consider the effect of a flat 10% on a single mother supporting her family working as a seamstress in a garment sweatshop for minimum wage ($10,000 per year) and the effect of a flat 10% on a corporate CEO earning ten million dollars per year. For the minimum wage seamstress, that ten percent is $1,000 -- a huge bite in the wallet for someone barely trying to survive. For the CEO, the bite is a million dollars. Sure, that's no small amount of change, but the CEO's income hardly come all form salary, so he/she might not pay these 10 % at all.

Table 3 shows the different taxpaying units among the world. Taxing individuals might be closer to fairness than taxing families or households. Since mathematical sum of incomes of two married individuals makes tax system neutral to the marriage but with the inclusion of the other members of the household the neutrality is lost.

TABLE 3
TAXING UNITS IN OECD COUNTRIES

Country	Taxpayer
Australia	Individual
Austria	Individual
Belgium	Family
Canada	Individual
Czech	Individual
Denmark	Individual
Finland	Individual
France	Family
Germany	Individual/Family
Greece	Individual
Hungary	Individual
Island	Individual/family
Ireland	Individual/family
Italy	Individual
Japan	Individual
North Korea	Individual
Luxemburg	Family
Mexico	Individual
The Netherlands	Individual
New Zeland	Individual

Norway	Individual/Family
Poland	Individual/Family
Portugal	Family
Slovakia	Individual
Spain	Individual/Family
Sweden	Individual
Switzerland	Family
Turkey	Individual
The UK	Individual
USA	Individual/Family

Source: Author and Alm, J. and M. Melnik, *Taxing the "Family" in the Individual Income Tax .Georgia State University, 2004*

No matter what taxable unit will be established the flat tax diverts the burden towards low income and middle class earners. It favors unearned income and doesn't tax it towards earned income that is taxed with low rate but deprived of all the deductions and exemptions. This makes the effective tax rate close to the marginal and as whole increases the tax liability of the people. By no means has the flat tax system "fairness" come to the stated fairness by Adam Smith in his fist principle of taxation:

> "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State".[5]

When Adam Smith wrote, governmental functions were few and uncomplicated. The division of the burden was seen as a simple matter of equity based on some quality of economic well being: the greater the financial capacity to pay, the greater should be the individual's contribution. It is generally taken for granted that an individual's income is the best measure of his economic well being and of his capacity to pay. Basically this philosophy is reflected in the current tax system, subject to one vital qualification. Adam Smith advocated proportionality: the notion that the proportion of the tax burden assumed should vary directly with the revenue which each subject received.

THE CHOICE OF THE TAX BASE

The flat tax defenders are saying that their system will simplify the tax return. That it will be like a postcard to the IRS. The idea is that it eliminates different deductions and treats all income equally. All incomes! So it assumes that there are different incomes which in fact require different schedules. After all the progressive tax system taxes the taxable income but figuring that taxable income lies in the complexity of the tax return.

Opposed to that I can say that people in a highest tax bracket in USA are paying in fact flat tax, even flatter than the one existing in all the post socialist countries, cause all the deductions and exemptions and credits are phased out so they pay flat income tax of 35%. But in reality they have to fill the same forms as those who can benefit from itemizing, exemptions, credits and other tax saving benefits. If you look at the state forms those with flat tax are more complicated than those with progressive – compare Massachusetts ones with New Jersey or Indiana with Minnesota and you will see the difference.

The flat tax is orientated mainly towards earned income, since it releases from taxation savings and investment with idea to stimulate growth. The definition of the tax base and in fact the taxable income is still necessary no matter what tax rate will be used for calculation.

Some terms are essential in understanding income tax law. "Gross income" can be generaly defined as "all income from whatever source derived;" a more complete definition is found in 26 U.S.C. § 61.

Other important definitions like "taxable income" and "adjusted gross income" can also be found in Chapter I of Title 26. These terms are not fixed nor should anyone be confident in understanding their true meaning after a cursory reading because their imputed definitions change with time.[6]

In othe rwords if the definitions of income are so dynamic and change so much the definition of the different type of income in numerous schedules will remain.

CONCLUSION

The flat tax "revolution" has started but is it really a revolution or just another of the numerous changes or social experiments in the tax system. The main conclusions here are that:

- The flat tax cannot stimulate growth in the amount stated by the flat tax defenders since it might distort the balance to payments much easily with the luxurious spending;
- The flat does not mean fair tax as for the moment the advantages of the progressive tax system in fairness has not changed since Adam Smith;
- The flat tax cannot contribute to the simplicty of the return although it might eliminate the deductions.

One thing is certain the flat tax "revolution" has helped many new faces to come to the field of taxation and run for office with these "revolutionary" ideas.

ENDNOTES

1. More on this can be found in Kornai for the process of budgetary formation and expenditures. Kornai, J, (1992) The socialist system: the political economy of communism, Princeton, N.J. 1992
2. See Tanzi, Vito and Milka Casanegra de Janscher (1987) "Presumptive Income Taxation: Administrative, Efficiency and Equity Aspects" IMF Working Paper, WP/87/54, August 17, 1987
3. Dunn, Douglas, 2007, Economic Justice and Fairness, http://www.wordwiz72.com/econ.html
4. See http://www.mikehuckabee.com/?FuseAction=Issues.View&Issue_id=5
5. Smith, Adam, *An Inquiry into the Nature and Causes of the Wealth of Nations* Indianapolis: Liberty Classics, Volume II, 1981 pp. 825 -828.
6. Legal Information Institute, WEX http://www.law.cornell.edu/wex/index.php/Income_tax