THE FLAT TAX: A NEW TREND IN THE EUROPEAN MEMBER STATES?

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Abstract

One of the most controversial tax developments in recent years, and one that continues to attract considerable attention, is the adoption by several countries of a form of “flat tax.” Is there a trend towards a flat tax? Will this trend continue? In which country the flat tax’s future is more problematic? In this study we summarize the main characteristics of the flat tax reforms in European countries. The qualitative and descriptive analysis suggests that Romania’s commitment to flat tax is the weakest, which makes this country a potential candidate for the reversal of the reform.

Actually, the flat tax is not an innovation in fiscal policy; it only looks like one, after a century of progressive taxation. This practice could be found only in some very small states or fiscal jurisdictions, like Honk Kong, Guersney and Jersey. The flat tax idea was revived in the sixties, when Milton Friedman (1962) proposed for the United States a federal tax of 23.5%. Hayek (1960) also objected to the need of progressive taxation in order to achieve redistribution of revenues. Later, Milton and Rose Friedman (1979) argued in favor of a federal tax less than 20%. Hall and Rabushka (1985) defended a similar point of view. The flat tax didn’t get the attention of many other researchers even when the Baltic States adopted this form of taxation for the personal income, in the mid nineties. They were three very small countries, who just gained their independence and their example was not followed by any other state, until 2001. The Russian Federation switch to the flat tax was a turning point: from now, almost each year, a new country adopted the flat tax. It was a signal that this topic deserves attention of researchers and even of the public opinion. After that, what seemed to be just a “Baltic experiment” can be considered now the starting point of the “flat tax revolution”, as it is sometimes called by mass-media. Is this a new trend
in taxation? What are the next countries to adopt the flat tax? What are the main characteristics of these tax reforms? What are the main threats to this process? What is the country which is the most likely to abandon the flat tax? The first part will present the main characteristics of the fiscal reforms in European countries and the second part will defend the idea that Romania is the country where the flat tax is most threatened.

1. The main characteristics of flat tax reforms in Europe

In a narrow sense, the flat tax means a proportional taxation of either personal or corporate income. A particular case is when the rates are identical for both types of income. The argument in favor of the later is to avoid or limit fiscal distortion between the two factors, labor and capital. The flat tax is presented as the antithesis of the progressive taxation, which means that the marginal tax rate increases with the tax base. With the notable exception of Georgia, no other country applies the flat tax in this narrow sense. Indeed, for the personal income tax, there is a basic allowance, which means that the income is taxed not at a “unique” tax but at two, the first one being zero. The consequence is that the personal income is taxed not at a flat rate but at a slightly progressive one even in the so called flat tax countries. In a larger sense – that retained in this paper – the flat tax refers only to the taxable income. Thereafter are presented the main characteristics of the flat tax reforms in European countries.

Estonia

In recent history, Estonia was the first country to adopt, in 1994, the flat tax on personal income (26%). There was a basic personal allowance which was increased. The corporate tax rate was reduced (from 35%) and set at the same level as the personal income tax rate. This example will be followed by other countries (Latvia, Slovakia, Romania). However, this doesn’t avoid tax distortion because of social contributions, which operate actually like a tax on labor factor. The reason is that the pension, health and unemployment systems are redistributing devices and there is no direct and strong link between contributions and benefits. In the case of a (hypothetical) total privatization of these mechanisms, there would be no reason to consider the contributions like taxes: they would be savings or insurance primes, like those for the car or the house. The flat tax reform in Estonia can be better understood if it’s integrated in the more general transition reforms started right after the independence. First of all, the flat tax was a part of a deliberate

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1 http://www.emta.ee/?lang=en
and long term plan of tax cuts, which will continue in the near future. For example, the corporate income tax will be lowered, to 20% in 2009. Moreover, since 2000, undistributed profits were tax exempted. This supply-side facility was maintained, despite official and unofficial pressures from the EU authorities and from the high tax state members. It will be adapted in 2009 in order to be insure the conformity with EU regulation. Second, Estonia was also the first European country in modern history (and one of the very few at world level) to adopt a unilateral and total liberalization of foreign trade, which represents the maximum reduction of custom duties. Third, Estonia was also the first European country to establish a currency board (1992), as a way to prevent and fight inflation, which is, after all, a particular form of taxation. Fourth, Estonia started an ambitious plan of rapid privatization, simultaneously with the instauration of the rule of law. In short, the Estonian flat tax fiscal reform was only a component of a broader free market oriented reform, but methodologically, it would be difficult to attribute the undeniable success of this reform to one or other of its component.

**Lithuania**

Lithuania adopted in 1994 the flat tax at the highest level of the previous progressive personal income tax (33%). This is also among the highest level among all flat taxes, with seven points more than the next ranked (Estonia) and only 3% less than the first (Iceland). This seems to contradict the very logic of the flat tax, supposed to be a stimulating and an incentive-compatible form of taxation. However, the basic personal allowance was significantly increased, in order to protect low income taxpayers. Since 2006, (July, 1st) the flat tax rate was reduced to 27% and it will cut to 24% in 2008 (January, 1st). The corporate income tax was also the highest among the Baltic States (29%), but it was later reduced to 15%, one of the lowest in European Union. Like Estonia, Lithuania adopted a currency board (1994), but was less enthusiastic in other reforms. Lithuania took a path similar to Estonia, but its commitment to free market principles was a little bit weaker.

**Latvia**

Latvia waited until 1997 before adopting the flat tax, like Lithuania, at the highest level of the tax rate of personal income (25%). However, because of the regressive structure of Latvian taxation, this actually increased the marginal tax rate, especially for higher incomes. The corporate income tax

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was left unchanged (25%). As a consequence, like in Estonia, the corporate and personal income tax rate had the same level. Even if it was initially a deliberate plan, this situation didn’t last. Following a strategy of fiscal competition, Latvia pushed down the tax rate on the more mobile factor, and now the corporate income tax rate is 15%, the same as in Lithuania³.

**Russia**

In 2001, Russia replaced the progressive taxation on personal income (12%, 20% and 30%) with a flat tax of 13%, a level surprisingly low, according to XXᵗʰ century. The personal allowance depends negatively upon the income level, which means that the tax rate is not flat but (slightly) progressive. However, the social security contributions are degressive (from 35.6% to 5%), as a mean to reduce tax evasion incentives. The corporate income tax rate was increased from 30% to 35% as well as the tax on dividends, from 15% to 35%. The results of the Russian fiscal reform were even more surprising for all who doubt that in the possibility of any “Laffer effect”. In 2002, the fiscal revenue form the personal income tax were 60% higher in nominal terms (Pogorletskyi, 2003) and with 26% higher in real terms (Ivanova et al., 2005, Keen et al., 2006). Ivanova et. al. (2005), Gaddy and Gale (2005) are recognizing (partially) the success of the reform, but they consider that it can not be attributable to the tax cuts in general and to the flat tax reform in particular. For example, they find little effects on labor supply but they estimates a high (“striking magnitude”) increase in compliance.

**Ukraine**

Ukraine implemented the flat tax in 2004, taking the Russian reform as a model. The progressive taxation (10% to 40%) was replaced with a tax on 13% on personal income tax. The personal allowance is decreasing to zero with the income. Under that level (1.4 the subsistence amount), the “flat tax” is actually progressive, above it, the tax rate is flat (proportional). The corporate income tax is significantly lower than the Russian equivalent: it was reduced from 35% to 25% and extended to other sector which previously benefited from different exemptions⁴.

**Slovakia**

Slovakia adopted the flat in 2004 as a part of a broader fiscal reform. One of its most noted characteristics is that there is a single tax rate (19%) for personal and corporate income but also for the VAT. There is no economic

reason for this identity, except, probably, to make more difficult (politically) any further modification of these tax rates. The reform represented a significant cut in previous tax rates on personal income (which ranged 10% to 38%) and on corporate income (25%). The most unpopular part of the reform was the unification of the dual VAT rate (14% and 20%). The reduced rate concerned many basic products, like food, medicaments, electricity, coal, books, newspapers, construction works etc. As a compensation for the VAT increase and for the higher flat tax at the lower income brackets, the personal allowance more than doubled, the spouse allowance increased sevenfold. Everybody with a wage below half of the average wage is not paying a personal income tax. In the long run, this could have undesirable consequences on citizens’ incentives and responsibility. Indeed, if an increasing part of the population doesn’t pay taxes, the opposition against tax increases or the demand for fiscal discipline and moderation can drop at a very low level\(^5\). Besides the adoption of the flat tax, the main characteristics of the reform (as resumed by Golias and Kicina, 2005) were: the shift of the tax burden from direct to indirect taxes, the elimination of exceptions, exemptions and special regimes, the elimination of tax instruments aimed at achieving non-fiscal goals and the elimination of double taxation of capital income (such as tax on dividends, which was 15% before the reform). Like in Estonia, the fiscal reform was inspired by a supply-side approach and it was deliberately conceived to encourage work, investment and entrepreneurship. The fiscal reform was accompanied by a liberalization of labor market and a redesign of social programs design to enhance the above mentioned incentive effects. As a political strategy, the most unpopular measures (unification of VAT rates) were approved first and only after that came the popular ones. During the campaign, the parties and NGOs who supported the reform had to be involved in real “battle of ideas” and to win it, especially after the law was vetoed by the Slovak President. This process offers a stronger guarantee that the political parties who supported the flat tax reform won’t change side and will continue to defend “their” reform.

**Georgia**

In 2005, Georgia dropped its progressive but very mild taxation of personal income tax (12%, 15%, 17% and 20%) and replaced it with the smallest – at that time – flat tax rate (12%). Because there is no personal allowance, the Georgian flat tax is also that which is the closest to the

theoretical model of proportional taxation. The social contributions were also reduced from 33% to 20%. The corporate income tax was left unchanged (20%)\(^6\). As in Estonia, the fiscal reform was a part of a very ambitious free market oriented program. Georgia reduced the minimum capital required to start a new business, simplified administrative and juridical procedures, liberalized the labor market, improved investors’ protection and contracts’ enforcement, facilitated foreign trade etc. As a consequence, Georgia was ranked as the “top reformer” in 2005-2006, by the World Bank’s Doing Business Report 2007. Moreover, this was not an exceptional and isolated event, Georgia was the second reformer in 2004. The most impressive is that all these reforms were initiated by a country confronted with strong separatist movements and with a \textit{de facto} occupation of a part of its territory by foreign forces. This is not the most favorable environment to a public discourse in favor of laissez-faire policies.

**Romania**

Romania replaced its progressive taxation of personal income (five taxes, between 18% and 40%) with a flat tax rate (16%), combined with a degressive personal allowance. As a consequence, Romanian taxation of personal income is slightly progressive. The corporate income tax was reduced (from 25% to 16%). However, the dividends paid to individuals were taxed, in 2005 at a lower rate (10%), and since 2006 at the same rate as personal income. This represents a double taxation of the capital factor (avoided by the Slovak tax reform), which brings the tax rate for an individual stockholder to 29.44% if all profits are distributed as dividends. In 2005-2006, Romania was ranked second in the reformers’ top established by the World Bank’s Doing Business Report 2007, a continuation and an improvement of the 2004 reform programs, when Romania was ranked on 8\(^{th}\) place by the same organization. Most of the reforms were market oriented, aimed to simplify and accelerate administrative procedures. This improved dramatically Romania’s Doing Business rank (from 71 to 49).

**Iceland**

In 2007, Iceland adopted a flat tax of 36% (cumulated rates, for local and central governments), which is the highest of the “flat tax club”. However, the reform is significant because it’s the first time when a Western country abandons the progressive taxation. Even more remarkable is that this reform took place in a society more sympathetic to the so called “Scandinavian

\(^6\) \url{http://www.mof.ge/?lang=EN}
model” of the welfare state. The corporate income tax (18%) and the tax on capital income (10%) are very low relatively to other OECD members\(^7\).

**Macedonia**

Macedonia adopted a 12% flat tax rate on personal income in 2007 and decreased the corporate tax rate from an already very low level (15%) to 12%. It announced its intention to reduce the personal income tax in 2008 to 10\(^8\).

**Albania**

Starting with 2008, Albania plans to introduce a flat tax of 10% on personal income tax, replacing the current progressive taxation (5%, 10%, 15%, 25% and 30%). The corporate income tax will be halved, from 20% to 10%, but dividends paid to individuals are taxed at 10\(^9\).

**Bulgaria**

In 2007, Bulgaria decided to adopt a 10% flat tax on personal income starting with 2008, significantly lower than the current progressive tax rates (20% to 24%). The Parliament approved on November, 23\(^{rd}\) the lowest tax in Europe and one of the lowest in the world, transforming the former communist country in a fiscal paradise. This measure comes after the reduction of corporate income tax to 10%, already accomplished in 2006\(^10\).

**Czech Republic**

In 2008, Czech Republic will replace the progressive taxation of personal income (12%, 19%, 25% and 32%) with a flat tax of 15%, supposed to be further reduced at 12.5% in 2009, but combined with an enlargement of the tax base, which will include, for example, social contributions. Like in a case study of fiscal competition, the corporate income tax will be reduced from 24% to 21% in 2008, and will be cut by 1% each year to reach 19%, the tax rate adopted by Slovakia\(^11\).

**2. Why the flat tax is under threat in Romania?**

There are more examples of countries which adopted or plan to adopt the flat tax, but we limited the analysis to the European countries. It appears that there is a “new trend” towards the flat tax in the EU members and in European countries in general. Another question is that if adopting the flat tax and lowering statutory tax rates is a sufficient condition to become

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\(^7\) [http://eng.fjarmalaraduneyti.is/](http://eng.fjarmalaraduneyti.is/) and Mitchell, 2007


“fiscally competitive”, to attract foreign investors and to stimulate local entrepreneurs.

Concerning the last question, when analyzing the Doing Business Report, one of the most counter-intuitive finding of the is that, Poland excepted, for all the 8+2 countries (the new EU continental member states) the “Paying taxes” ranking is (much) lower than their overall “Doing business” ranking. Indeed, this not exactly what one would expect for countries accused to practice a fiscal dumping. Besides, the differences between these two rankings are the highest for Romania (82 and 71 places, Slovakia (78 and 75) and Latvia (75 in 2005), all members of the “flat-tax club” and with a relatively low statutory corporate tax rate (16%, 19% and 25% respectively). At world level, the largest differences between the “Fiscal freedom”, measured principally by the statutory tax rates (Gwartney et al., 2006) and “Paying taxes” rankings were for Denmark (+134) and for Bolivia (–128). These two countries are the extreme examples of a situation with a very high statutory tax rates but easy to pay and, respectively, with low statutory tax rates combined with enormous compliance costs. In the 8+2 countries, the extremes are Slovenia (+91) and Romania (–87). Romania and Slovakia are penalized in “Paying taxes” ranking by the non monetary fiscal burden (number of payments and time of compliance). According to this indicator, the main advantage of the Baltic States is the number of payments and not only the low tax rates. This suggests the directions of further reforms in taxation field. It is more difficult to answer the first question: from all the countries which adopted the flat tax, which one is the weakest link? However, there are at least four elements which suggest that Romania is one of the candidates to this position.

**Conclusion**

The flat tax trend is likely to continue in the near future, as a specific form of fiscal competition. Despite the success of these reforms – especially when combined with other tax cuts and free market oriented programs – there is a strong opposition against them, both internal and external. Among those who adopted it recently, there is no yet an example of a country abandoning flat tax for progressive taxation, although some opposition parties are promising to do so if they win the elections. The flat tax is under threat in many countries, but its future is more problematic in Romania.
5. Friedman, M., Capitalism and Liberty, Chicago, Editura Universitatii, 1962
25. SAR (2003), Rapoarte asupra guvernării. Ediție specială Nr. 2 August, www.sar.org

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