

# Lessons from abroad

## International evidence shows flat tax benefits

*Patrick Basham*

IN North America, a flat tax system may be characterized by some as a “nice theory,” but one that isn’t “practical.” Some doubters think that a flat tax would not work. Others think that the ideological objections are too formidable or that beneficiaries of current tax regimes are too powerful to overcome; consequently, a flat tax will never be enacted.

In truth, the flat tax is anything but a theoretical policy experiment. There are now more than 20 jurisdictions using the flat tax and this number is expected to continue to grow (table 1). Most of the flat tax nations are transition economies in Eastern and Central Europe, but there are a handful of wealthy economies that use this simple and fair tax system. The flat tax is a proven instrument of sound fiscal policy.

### The benefits of a flat tax

THE modern flat tax has a record of accomplishment that is six decades long. The Southeast Asian territory of Hong Kong built itself into an economic giant upon the fiscal anchor of the flat tax (Littlewood, 2007). It has been almost a half-century since the island of Guernsey joined its Channel Island neighbor, Jersey, as a flat-tax jurisdiction. Although both jurisdictions have autonomy over fiscal issues, neither Hong Kong nor the Channel Islands are independent or autonomous countries. More recently, a number of Central and Eastern European countries have enacted flat taxes on personal or corporate income, or both. These countries provide a global, or at

least a regional, proving ground for the flat tax concept.

Pessimistic predictions about the flat tax have been proven wrong. The international evidence strongly suggests that the flat tax has stimulated positive economic performance and improved economic growth. In 2004, for example, GDP growth rates in countries with a flat tax exceeded the worldwide average growth rate of major industrialized countries (*Wall Street Journal*, 2005). Transition economies should grow faster, of course, as part of a convergence process, but transition economies with flat tax systems are growing more rapidly than transition economies with so-called “progressive” tax rates (cf. McMahon, 2000a; 2000b).

According to the Economist Intelligence Unit (2005), flat tax rates are unlikely to undermine government revenue. In fact, revenue has not dried up in countries that have adopted the flat tax. This revenue outcome comes as a surprise to many, but it should not, as there exists a strong correlation between low or reduced tax levels and revenue stability.

Former communist countries in Central and Eastern Europe are the most prominent experimenters with a flat tax system. Most of them were, in effect, starting with a blank fiscal slate. Consequently, they opted for the simplest, most efficient system. The Baltic countries took the lead, as Estonia became the first of the post-communist nations to adopt the flat tax. Lithuania and Latvia quickly followed. Since their adoption of a flat tax, the three Baltic nations have experienced such strong economic growth, increases in foreign investment, and declines in unemployment that they

are now known as the “Baltic Tigers.” Now, other nations are following their lead and experiencing good results.

International experience with the flat tax also demonstrates that tax evasion is reduced as activity is shifted from the black economy to the legitimate economy. As flat tax rates are relatively low, the incentive for tax evasion is also reduced,

**Table 1: Flat-tax jurisdictions—personal income taxes**

Jurisdiction	Year of enactment	Tax rate
Jersey	1940	20%
Hong Kong	1947	16%
Guernsey	1960	20%
Estonia	1994	22% (orig. 26%)
Latvia	1995	25%
Lithuania	1996	27% (orig. 33%)
Russia	2001	13%
Serbia	2003	14%
Slovakia	2004	19%
Ukraine	2004	15% (orig. 13%)
Iraq	2004	15%
Romania	2005	16%
Georgia	2005	12%
Iceland	2007	35.70%
Monogolia	2007	10%
Krgyzstan	2007	10%
Macedonia	2007	12%
Montenegro	2007	15%
Albania	2007	10%
Czech Rep.	2008	15%
Bulgaria	2008	10%
Mauritius	2009	15%

Source: Mitchell (2007: 10).

usually by a significant margin. In addition, the Cato Institute's Dan Mitchell found that the flat tax "has curtailed interest-group pleading in Eastern Europe" (Mitchell, 2005).

Natasha Srdoc-Samy, president of Croatia's Adriatic Institute for Public Policy, summarized the post-communist Central and Eastern European experience in this way: "Flat taxes also carry a promise to free up economies for growth, by forcing gray economic activity into the legitimate market and simplifying collection. Economic activity increases, and so does honest reporting of income, while tax evasion drops" (Srdoc-Samy, 2007).

Although the absence of a withholding tax in Hong Kong constitutes a significant difference between the Hong Kong and European systems, the flat tax is simple to understand and simple to pay in both Europe and Hong Kong. The straightforwardness of the flat tax system vastly reduces the cost to the tax collector. Even more important, taxpayers are much less likely to need professional assistance to comply with a simple tax code, which is another reason why the flat tax saves taxpayers enormous sums of money. Billions of dollars are saved in compliance costs, as a tax return can be filled in quickly with minimal paperwork (Herbert, 2005).

## Overcoming political obstacles

THE economic argument for adoption of a flat tax is a very strong one, indeed. However, whether more rooted economies in the West actually adopt the flat tax will depend as much on political considerations as economic ones. Consequently, a discussion of the political factors that have encouraged adoption in Central and Eastern Europe, for example, will be useful.

Anachronistic conceptions of fairness and social justice are the principal rea-

son that most Western countries have progressive tax systems.

Kevin Waddell, vice president of the Boston Consulting Group, has articulated the obstacles to adopting the flat tax in Western European nations—obstacles that are equally apparent in the US or Canadian context. In Waddell's view, "[t]he challenge that Western Europe has is that you have a lot of entrenched interest groups. When you try and put in place a flat tax, you take something away from somebody else" (Tzortzis, 2005).

Then is the introduction of a flat tax here a lost cause? No, it is not a lost cause, or it need not be one. Proponents of the flat tax can derive encouragement from finding that a tax system cluttered with credits, deductions, and exemptions contains the seeds of its own destruction. As T.J. DiLorenzo explained:

The granting of loopholes by politicians is subject to diminishing returns, just as all other activities are. The political benefit of granting additional tax preferences will fall over time. It is also likely that the political costs (to the politician) are rising, for with increased complexity of the tax system comes greater dissatisfaction on the part of voters who complain that the tax system is too complicated and unfair. Thus, at some point it is not politically profitable to create further loopholes. (DiLorenzo, 1985)

The experience of Central and Eastern European countries with the flat tax is a contemporary example of how radical tax reform can succeed (cf. Evans, 2007). Politically successful flat-tax proposals in Central and Eastern Europe share the following three characteristics:

- 1 These proposals are large scale rather than piecemeal. It is easier to implement simpler, more radical reform than more complicated, gradual re-

form. Slow and partial reforms do not work; fast and deep ones do work.

- 2 The flat tax rates set by these proposals are at relatively low levels.
- 3 These proposals include lower ratios of tax to GDP and government spending to GDP.

The international flat tax experience confounds Hettich and Winer's (2005) cynical assertion that it is possible to have democracy or a flat tax, but not both. The most telling sign, perhaps, of the flat tax's suitability to the modern capitalist economy is that no country that has introduced the flat tax has reversed course and re-adopted a progressive tax system.

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*This article is based on a chapter in the recently released Fraser Institute book examining flat tax reform. The chapter was written by both Patrick Basham and Daniel Mitchell.*