

## THE FLAT TAX – A COMPARATIVE STUDY OF THE EXISTING MODELS

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*In the two last decades the flat tax systems have spread all around the globe from East and Central Europe to Asia and Central America. Many specialists consider this phenomenon a real fiscal revolution, but others see it as a mistake as long as the new systems are just a feint of the true flat tax designed by the famous Stanford University professors Robert Hall and Alvin Rabushka. In this context this paper tries to determine which of the existing flat tax systems resemble the true flat tax model by comparing and contrasting their main characteristics with the features of the model proposed by Hall and Rabushka. The research also underlines the common features and the differences between the existing models. The idea of this kind of study is not really new, others have done it but the comparison was limited to one country. For example Emil Kalchev from New Bulgarian University has asses the Bulgarian income system, by comparing it with the flat tax and concluding that taxation in Bulgaria is not simple, neutral and non-distortive. Our research is based on several case studies and on compare and contrast qualitative and quantitative methods. The study starts form the fiscal design drawn by the two American professors in the book “The Flat Tax”. Four main characteristics of the flat tax system were chosen in order to build the comparison: fiscal design, simplicity, avoidance of double taxation and uniformity of the tax rates. The jurisdictions chosen for the case study are countries all around the globe with fiscal systems which are considered flat tax systems.*

*The results obtained show that the fiscal design of Hong Kong is the only flat tax model which is built following an economic logic and not a legal sense, being in the same time a simple and transparent system. Others countries as Slovakia, Albania, Macedonia in Central and Eastern Europe fulfill the requirement regarding the uniformity of taxation. Other jurisdictions avoid the double taxation but they have several tax rates for different types of income. Analyzing the flat tax jurisdiction we concluded that none of the existing models is a true flat tax as designed by Hall and Rabushka.*

*The study is important given the fact that it can provide useful information for future studies in connecting the effects generated by the adoption of flat tax with the design of the system. This can give intelligence for the exiting models in correcting and improving their features in order to become more efficient. This can also provide precious design information for the jurisdictions desirous of implementing flat tax systems.*

*The added value of this paperwork consists in the determination of the main features of the existing flat tax systems in relation with the theoretical system designed by Hall and Rabushka and in the fact that it provides precious structured information for future studies allowing to connect the effects of the flat fiscal model with its characteristics.*

*Keywords: flat tax, simplicity, uniformity, rates*

*JEL Codes: H20, H24, H25*

## **1. Introduction**

Over the last two decades the flat tax became a real fiscal phenomenon. Many countries in transition, but also developed jurisdictions all over the world have adopted this system in order to give their economies an impetus.

Along with the idea of a flat tax have appeared the theories which advocate this system and also the theories which show that it does not represent a viable solution. The pro and cons of the flat tax system are not yet exhausted, theorists, practitioners, politicians and even journalists worldwide try to determine the social, fiscal and economic efficiency of this construction.

The debate over the flat tax is yet concentrated on rhetoric arguments and is based on assertion rather than analysis and evidences.

The present global economic crisis has brought to viewfinder the problem of finding fiscal solutions in order to overcome the social and economic negative effects of the crisis. With this occasion the flat tax system became an important spark discussion point. Some economists blamed the flat tax idea, trying to demonstrate that these systems represent one of the indirect, yet important, causes of the international economic crisis because of their character which generates inequities and social bias. More than that, some specialists consider the flat tax is the main cause of the financial problems in the Baltic region. Yet no country which adopted a flat tax, less Iceland, has given up this fiscal construction.

In the modern world there are no perfect fiscal systems, but improving the existing ones is goal for any jurisdiction. More over, it is well known that fair taxes are not efficient and efficient taxes are not fair. Although the recipe for the perfect taxing system was not found in terms of fairness and efficiency, our study tries to bring a small contribution to the diagnosis and improvement of the existing flat tax system.

The specific objectives of this research are:

- Determining the common elements and the differences between the existing flat tax models:
- Generating research assumptions which may represent the leading point for future research studies.

## **2. The Flat Tax of Hall and Rabushka**

We began our research from the “Bible” of the flat tax, the book “The Flat Tax” written by Robert Hall and Alvin Rabushka in 1985. In this work the two American professors define the flat tax system by drawing its main features.

The flat tax is a very simple consumption tax system. Following not a legal sense, as other tax systems, but economic logic the integrated flat tax design is utmost simple – its two tax forms fits on postcards. The income is divided in two categories: individual wage tax, which includes wages, salaries and pensions, and business income which include all other types of income. The taxation for individual wage tax is made using a single form which fits a postcard:

Form 1		Individual Wage Tax		1998
Your first name and initial (if joint return, also give spouse's name and initial)		Last name		Your social security number
Present home address (number and street including apartment number or rural route)			Spouse's social security number	
City, town, or post office, state, and ZIP code			Your occupation™	
			Spouse's occupation™	
1	Wages and salary.....	1		
2	Pension and retirement benefits.....	2		
3	Total compensation (line 1 plus line 2).....	3		
4	Personal allowance			
	(a) <input type="checkbox"/> \$16,500 for married filing jointly.....	4(a)		
	(b) <input type="checkbox"/> \$9,500 for single.....	4(b)		
	(c) <input type="checkbox"/> \$14,000 for single head of household.....	4(c)		
5	Number of dependents, not including spouse.....	5		
6	Personal allowances for dependents (line 5 multiplied by \$4,500).....	6		
7	Total personal allowances (line 4 plus line 6).....	7		
8	Taxable compensation (line 3 less line 7, if positive; otherwise zero).....	8		
9	Tax (19% of line 8).....	9		
10	Tax withheld by employer.....	10		
11	Tax due (line 9 less line 10, if positive).....	11		
12	Refund due (line 10 less line 9, if positive).....	12		

**Figure 1: Individual wage – tax form**

Source: Hall and Rabushka 2007: 94

The business tax is a giant, comprehensive withholding tax on all types of personal income other than wages, salaries, and pensions, but the taxation is also made using a very simple form:

Form 2		Business Tax		1998
Business name		Employer identification number		
Street address		County		
City, state, and ZIP code		Principal product		
1	Gross revenue from sales.....	1		
2	Allowable costs			
	(a) Purchases of goods, services, and materials.....	2(a)		
	(b) Wages, salaries, and pensions.....	2(b)		
	(c) Purchases of capital equipment, structures, and land.....	2(c)		
3	Total allowable costs (sum of lines 2(a), 2(b), 2(c)).....	3		
4	Taxable income (line 1 less line 3).....	4		
5	Tax (19% of line 4).....	5		
6	Carry-forward from 1997.....	6		
7	Interest on carry-forward (6% of line 6).....	7		
8	Carry-forward into 1998 (line 6 plus line 7).....	8		
9	Tax due (line 5 less line 8, if positive).....	9		
10	Carry-forward to 1999 (line 8 less line 5, if positive).....	10		

**Figure 2: Business wage – tax form**

Source: Hall and Rabushka 2007: 94.

Another important feature of the flat tax defined by Hall and Rabushka is that it taxes once and only once all types of income.

The flat tax also means that business income and worker income are taxed at the same single tax rate.

### **3. Methodology**

This paper represents a scientific approach focused on relevant case studies in the area of flat tax constructions research. This systemic and comparative research starts from the theoretical flat tax model designed by Robert Hall and Alvin Rabushka in 1985.

In the research process four main characteristics of the theoretical model are selected in order to build the comparison:

- simplicity;
- fiscal design;
- avoidance of double taxation;
- tax rates uniformity.

Through these characteristics, the similarities and the differences between the flat tax systems in different jurisdictions of the world are found. For a systemic approach the jurisdictions are analyzed grouped in regions. For each region were selected the most relevant cases for our research.

In the first place the flat tax systems from Asia are analyzed. For the comparison with the theoretical model was chosen Hang Kong, taking into consideration the age and the performances of this fiscal construction.

The flat tax systems from Eastern and Central Europe are also studied. The flat tax became a part of the fiscal landscape of the ex-communist countries since 1994 when Estonia adopted a flat tax. The idea spread rapidly, countries like Lithuania, Latvia, Russia, Serbia, Slovakia, Ukraine, Georgia, Romania, Albania, Macedonia, Monte Negro, Bulgaria, Czech Republic, Slovakia and Hungary have also adopted this type of system.

The issue regarding the flat tax is also studied for Western European Countries. The fiscal design of Guernsey and Jersey, two of the oldest flat tax systems in the world, are compared with the theoretical model. In Western Europe we find the first country in the world which gave up the flat tax construction.

The American continent has also some jurisdictions with flat tax systems: Paraguay and Jamaica.

## **4. Results**

### ***4.1 The Flat Tax in Asia***

In Asia there are six countries which have a flat tax system: Hong Kong, Mongolia, Turkmenistan, Kyrgyzstan, Kazakhstan and Iraq. Hong Kong flat tax was adopted in 1947 and is one of the most efficient fiscal systems in the world taking into consideration the fact that the budget of this jurisdiction was on surplus for decades on a row.

Comparing the flat tax constructions of these countries with the model designed by Hall and Rabushka, some differences and similarities appear.

In terms of simplicity Hong Kong is the champion. The taxpayers declare their income once a year and there is no withholding tax so the each person, business or individual has to declare his or hers income.

In the other five countries the systems are not that simples, the fiscal tasks are more complex and appear more often.

The Hong Kong fiscal design resembles the design proposed by Hall and Rabushka. The treatment of the income in this Chinese jurisdiction follows an economic logic and not a legal

sense, so that income is divided in wages income and business income. The other Asian states treat the different types of income from a judicial point of view.

Avoiding double taxation is an accomplished rule in Hong Kong as long as dividends and capital gains are not taxed.

Analyzing the tax rates in Hong Kong one can see that there is a difference of 1.5% between the tax rate used for taxing business income and the tax rate for wages, salaries and pensions. There is also an important legal foresight regarding the salaries under a certain ceiling: one can choose between a progressive taxation with rates ranging from 2% to 17% and a proportional taxation. But this progressive taxation can be interpreted as a system of allowances for the poorer taxpayers.

In Mongolia the taxation is made using an uniform rate for personal income and two tax rates for the profit. In Turkmenistan, Kyrgyzstan and Kazakhstan the uniformity of the rates is verified only for personal income.

#### ***4.2 The Flat Tax in Eastern and Central Europe***

In the last two decades many of the ex-communist European countries have adopted flat tax systems. The first one was Estonia in 1994 and many others follow: Lithuania in 1995, Latvia in 1997, Russia in 2001, Serbia in 2003, Slovakia and Ukraine in 2004, Georgia and Romania in 2005, Macedonia and Montenegro in 2006, Czech Republic in 2007, Belarus, Albania and Bulgaria in 2008 and Hungary in 2011.

The fiscal design of the flat tax countries in Central and Eastern Europe is still a complex one. Unlike the flat tax, the separation of both taxation structures in all the countries of this region does not follow economic logic, but a legal sense, generating complications and double regulation of business income.

In terms of avoiding double taxation there just a few countries like Slovakia and Serbia comply with this rule. The other countries in the region tax dividends and/or capital gains, generating double taxation. This is the case of the Czech Republic, Bulgaria, Romania, Belarus, Montenegro, Macedonia and many others.

The uniformity of the tax rates is the most important feature of a flat tax system. This characteristic is accomplished by Estonia, Slovakia, Albania, Macedonia, and Montenegro.

#### ***4.3 The Flat Tax in Western Europe***

Western Europe remains an impregnable redoubt for the flat tax. The only two jurisdictions in this region which have adopted a flat tax system are Guernsey and Jersey, also known as the Channel Islands.

The fiscal systems from the two islands are relatively simple. Their simplicity comes from the uniformity of the tax rates used for all kind of income, but the declaration procedure is classic.

The fiscal treatment of the revenues is made by classifying the income using classic legal principles and not economic rules. For example in Guernsey the income is divided into wages and salaries, dividends, interests, income of sole proprietors and corporate income.

Double taxation is a reality in these jurisdictions, as income from dividend is taxed both in Guernsey and Jersey.

Taxing in the Channel Island is made uniformly. There is an exception in Jersey where the income of the companies from the financial sector is taxed with a rate of 10%, while all the other types of income are taxed with 20%.

#### ***4.4 The Flat Tax on the American Continent***

There are two major countries in Central and South America which have embraced the flat tax idea: Paraguay and Jamaica. Till 2010 in Paraguay the personal income was not taxed. Starting 1<sup>st</sup>

January 2010 the personal income is taxed with a rate of 10%, the same tax rate used for corporate income.

Jamaica adopted a flat tax in 1986. In 2010 Jamaica introduced a progressive taxing system for personal income, but the authorities from this state readopted a fat tax in March 2011.

The Jamaican and the Paraguayan fiscal systems are far from resembling the flat tax system designed by Hall and Rabushka. These systems are not simple; their complexity is being reflected by the diversity of tax rates used for imposing different types of income. The rule regarding the avoidance of double taxation is violated by taxing the dividends in both countries. The classification of the revenues in these American jurisdictions is made following a legal logic and not an economic sense.

## **5. Conclusions**

Analyzing the flat tax systems by comparing and contrasting them with the fiscal model designed by Hall and Rabushka, we obtained some interesting results.

The comparative study shows that the differences between the theoretical flat tax model and the existing flat tax constructions are the rule, whereas similarities are rather the exception.

The fiscal constructions became simpler by adopting the flat tax, especially because the rates become uniform for the all types of income and the taxing procedure is easier to perform. But none of the flat tax jurisdictions analyzed is as simple as the theoretical model.

The general design of the flat tax systems in Europe, Asia and America is based on legal principles and not on economic fundamentals as the flat tax of Hall and Rabushka. The exception is represented by the Hong Kong flat tax model, which is the only fiscal construction in the world following an economic logic.

Some countries have uniform tax rates for all types of income, but others use flat rates only for personal income.

Avoiding double taxation is a principle often violated by the majority of the flat tax countries, excepting Hong Kong and a few jurisdictions from Europe.

All in all we can conclude that there is no fiscal construction in the world which goes all the way with the theoretical model design by the two famous American professors. Yet the system that resembles the most the theoretical construction is the one of Hong Kong. But the questions that remain are which of the existing models are the most efficient ones and which are their characteristics generating the desired economic and social effects.

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