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The Craggy Flat-Tax Reform

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CHAPTER 1 A THEORETICAL APPROACH

In simple words, the *flat tax* entails the implementation of a tax system operating on a single level of taxation. In such a system, the calculating mechanisms for taxes related to various levels, be they progressive or regressive, are replaced by a single level of taxation for income that exceeds a determined threshold. The flat tax is implemented based on the supposition that all income is taxable once during its circulation and this occurs at the moment of its possession. Consequently, the concept of the flat tax involves the reckoning of taxes in two taxing planes: in the case of individuals, it is implemented on personal income and, in the case of businesses, it is imposed on the business income.

If we consider taxation systems from a historical perspective, we notice that during the first half of the 19th century, the implementation of a single level of taxation was the accepted norm in most industrialized countries. One of the first challengers of this system was Karl Marx, who, in his 1848 *Communist Manifesto*, suggested "progressive or escalating income tax" [1]. However, the later economic developments showed what we all know today: contrasting various prospects, it was the capitalist world which implemented Marx's suggestion.

Since that period, the idea of establishing a flat tax has been reconsidered many times in several countries. There has been a special focus on this concept, particularly in recent years, when a good part of the transitional post-communist economies in Central and Eastern Europe chose to implement this taxation alternative. Despite the growing intensity of the frequent debates, no Western economy has returned to the implementation of a tax regime based on the concept of flat taxation.

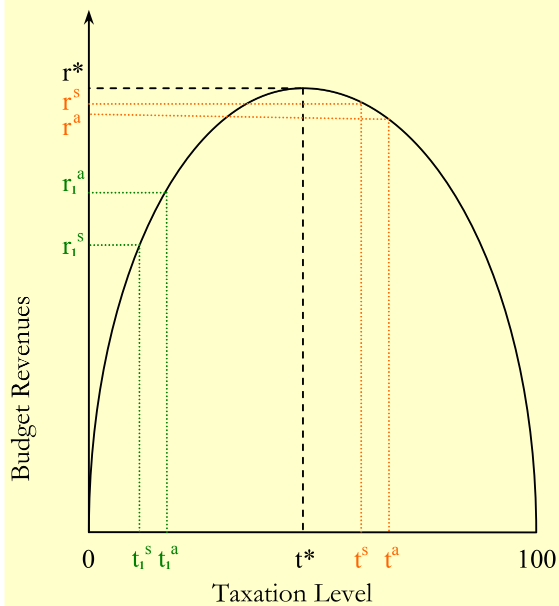
The Relation Between Level of Taxation and Tax Revenues:

The Laffer Curve

Aiming to offer several theoretical considerations regarding the systems and levels of taxation and their effects, it is necessary to reflect on the concept known as the Laffer Curve. Dr. Arthur B. Laffer is renowned for his explication of the relation between the level of taxation and public revenues produced by tax collection. This relation is the theoretical basis justifying the flat tax's effects on general tax revenues, given that this reform is introduced as a way to increase the latter.

[1] [2. A heavy progressive or graduated income tax.]
http://www.anu.edu.au/polsci/marx/classics/manifesto.html

The Laffer Curve suggests that tax revenues suffer immediate alterations when the level of taxation changes. On the left side of the abscissa axis, the lowering of the level of taxation from t_1^a causes a decrease in general tax revenues at a value equal to $r_1^a - r_1^s$. When the level of taxation is higher (as represented in the section close to t* at the abscissa axis) general revenues are less conditioned by shifts in the level of taxation. Therefore, public authorities collect the maximum amount of tax revenues at the optimal taxation point t*. Beyond this point, each growth in the level of taxation tends to incite individuals to work less or make more attempts at tax evasion, thus, inevitably reducing the amount of tax revenues. At a hypothetical 100% taxation level, there would be no incentive for anyone to work seeing as public authorities would be collecting the totality of incomes.



Note: The data in this diagram is not escalated; the value of t* can be anywhere between 0 and 100 and it is not necessarily close to 50% as it is represented in the picture.

As this graph illustrates, no lowering of the taxation level can ensure an increase of general tax revenues. In the cases when the present taxation level (t^a) is situated on the right side of the t*, a decrease in the level of taxation will ensure an increase in tax revenues. The higher the current level of taxation is (i.e., the t^a value closer to 100%), the more positive the effect will be on the revenues $r^s - r^a$ which are caused by a decrease of $t^a - t^s$ in the taxation level. If the level of taxation before the implementation of the fiscal reforms is located on the left side of the t*, then, the lowering of the taxation level $t_1^a - t_1^s$ does not ensure an increase in tax revenues, therefore, $r_1^s < r_1^a$. In addition, the lower the current taxation level is (i.e. the closer to 0 the t_1^a value is), the more negative the effect will be of lowering the level of taxation on general tax revenues. Therefore, this reasoning clarifies how successful fiscal reforms of the flat-tax type are determined by the quality and depth of preliminary analysis.

On the other hand, the Laffer analysis relates to another aspect which explains how the government can opt to implement one of two different methods of collecting an equal amount of revenue: either, by applying a high taxation level aimed at a limited segment of society (high taxes implemented on a tight taxation basis) or, by applying a low taxation level aimed at an extensive segment of the population (low taxation expanded to a broad taxation basis).

Consequently, by opting for one of the two abovementioned alternatives, effective fiscal reforms can be realized. In the case of the second alternative, the reduction of the taxation level would cause an increase in budget revenues, notwithstanding the current taxation level, before the implementation of the flat-tax reform (higher than the optimal value of t*).

Another claim flat-tax supporters make in favor of this alternative fiscal reform is related to the conviction that the existing systems of progressive taxation create hurdles in some aspects, for example, the lack of secondary employment incentives (the philosophy of flat taxation supports the idea of eliminating double taxation) or the contraction in savings and investments on a nation-wide economic scale.

Furthermore, flat-tax supporters take for granted the fact that the current level of taxation is higher than the optimal value of t*, as described in the Laffer analysis thus believing that a moderate/lower and flat taxation level would cause an increase in tax revenues. The fundamental argument supporting such theory is that, with a lowering of the taxation level, people would have more incentives to work, save and invest; consequently, the entire economy would benefit from this.

Yet, *there is another way of theoretically "juggling" with the Laffer analysis: by using the same variables but by taking a different viewpoint.* If the main goal is keeping tax revenues at the same level (counting on some modest increases) and not raising them in the short term, then the lowering of the taxation level would cause a broadening of the taxation basis. *This case can be advantageous for a country affected by high and widespread market 'informality', where the concept of Laffer's Curve would be seen as a possibility to 'formalize' the economy, i.e., broadening the taxation basis. However the curve has its binding limits, making the above supposition true only in the case where the taxation level before the implementation of the flat tax is beyond the optimal value of t*.*

One of the biggest problems that policymakers have encountered throughout the years when dealing with the Laffer Curve is the identification of the taxation level in this curve. The reason for this, is that the taxation level is not easily computable, thus, undermining a policy's chances for success, especially if it has served as the only grounds for implementing the flat-tax system.

The Flat-Tax Regime According to the Hall-Rabushka Proposal

A practical implementation of fiscal theories, in the form of a genuine taxation reform was presented in the year 1985, when Robert Hall and Alvin Rabushka from the Hoover Institute published the book *Flat Tax*. Steve Forbes, one of the media and economic tycoons baptized this publication "The flat tax bible". The fiscal reform according to the Hall and Rabushka approach aims at fundamentally changing the way the government organizes the collection of tax revenues. It is based on a single taxation level for all income sources which are subject to taxation only once, at the moment of possession. This proposal aims at simplifying and increasing the economic efficiency of tax declaration, traditional characteristics of an effective taxation system. Moreover, it permanently ensures agreeable levels of revenue for the funding of public expenditures.

The proposed 'flat-tax' reform's essential characteristic is that *all income is subject to taxation only once,* preferably at the source. The applied systems of progressive taxation cannot abide by this principle since various kinds of income, as a dividend or capital profit, will be subject to repeated taxation. The authors argue that by radically simplifying the taxation system, i.e., by eliminating repeated taxation; the flat tax would then free the current system from these anomalies, making it more efficient.

The other fundamental aspect of flat tax, according to Hall and Rabushka, is that *all income is subject to a uniform taxation,* without discrimination in the level of taxation depending on the amount of income. All kinds of income are classified in two general categories: business income or profit and salary or wage. Both these categories of income are subject to taxation at an equal level. The only exception made by the Hall-Rabushka proposal, which is conceptually similar to progressive taxation, is a generous lowering of taxation for individuals and families with an income lower than a certain minimum amount.. As a result, this proposal frees families with an income below the minimum living standard from paying income tax, while those who surpass this limit will be subject to taxation only for the amount of income beyond this limit.

<u>Personal Income Tax.</u> According to the Hall-Rabushka proposal, the payments in the form of remuneration, including benefits received from insurance schemes are considered personal income and are subject to personal income tax. Profits from dividends, capital profit or profit from bank interest or loan interests are not subject to the personal income tax as they have already been subject to taxation once at the source, through business income tax.

When it comes to the practical implementation of the flat-tax system, individuals and families calculate the amount of all the kinds of income they earn according to the above definition and then deduct the amount which is considered necessary for minimal living standards. This action is justified since the system allows for freedom from taxation for income beyond the minimum tolerance level at the end of the declaration of income period. This amount is then multiplied by the level of the flat tax so as to determine to absolute amount of taxes that individuals or families are subjected to at the end of the year. It is clear that the Hall-Rabushka proposal refers to countries with a taxation system based on annual tax declaration.

Personal Income Tax = Flat Tax x [Remunerations + Wages + Pensions, etc *minus* minimum tolerance level]

<u>Business Income Tax.</u> The second category of the Hall-Rabushka system is described with special care to avoid repeated taxation. The business revenues which are subject to taxation are calculated by deducting three kinds of expenditures from the total amount of revenues that the business has produced by selling its products or its services. *Firstly*, the company will deduct the wages or remunerations paid to employees, being that those will be subject to personal income taxation. *Secondly*, the company deducts the amount of products or services purchased from other companies, since those taxes will be gathered from the selling companies. *Thirdly,* the company must deduct all the costs of its investments in machineries, plants or other equipment as expenditures in their purchase year.

This immediate deduction of the investments encourages the creation of capital and eliminates possible abuses in the estimation of the amortization and administrative costs for the machineries' assessment.

Business Income Tax = Flat Tax x [Total income from the sale of the products *minus* the amount of remunerations and wages for employees *minus* the amount of purchases from other companies *minus* the amount of machinery, plants or equipment purchased]

Based on the above interpretation of this multidimensional reform known as the *flat-tax reform*, which evidently surpasses the simple criteria of evening out the taxation level, the authors positively prove that the flat tax is a *tax based on consumption*. It ensures a considerable drop of taxation for new investments made by companies and frees individuals from repeated taxation on their dividends and interest earned.

If implemented with all its elements, in line with the Hall-Rabushka proposal, the flat-tax reform aims to increase the national tax system's efficiency and, at the same time, does not threaten the level of public revenues since it is a taxation system based on consumption. According to this reasoning, it is natural to expect a considerable increase in savings and investments and, consequently, the creation of market capital – essential elements to ensure sustainable economic growth.

The Hall-Rabushka flat-tax reform has been implemented in several cases and was a source of inspiration for fiscal reforms in various countries. However, the practical implementation of this fiscal system has seen numerous modifications to and deviations from its original proposal. Even though the argumented presetation of a flat-tax system tends to be persuasive on the success of such a reform, at least from the theoretical point of view, experiences and empirical data from the countries that have implemented flat-tax reforms suggest that the implementation of this model is also a challenge and its success is yet to be proven in reality[2].

The Complex Socio-Economic Effects of the Flat Tax

Even though the flat-tax regime has not yet gained the status of 'magic formula' that would cure all contemporary economic diseases, a growing number of countries, among which a good part of the new EU member States, have adopted or are underway to implementing fiscal regimes of the flat-tax type. Experience has shown that a considerable number of these countries have had to face significant budget deficits. When implemented in its totality and in detail, the flat-tax regime is thought to bring reciprocal effects which, depending on the specific conditions of the economies that chose its implementation, can become a success or a failure within the context of socio-economic reforms in these countries.

[2] IMF Working Paper WP/06/218, *The "Flat Tax(es)": Principles and Evidence*, Michael Keen, Yitae Kim, and Ricardo Varsano.

Succinctly , the flat tax is thought to be advantageous in:

- The reduction of administrative and beaurocratic tax procedures and the difficulties and confusion that accompany them;
- The equality it guarantees in citizens' contributions (taxation fairness) through the implementation of the same taxation level for all classes;
- The absorption of foreign investments, in cases when the economic system does not have barriers of another nature;
- Reducing the chances for tax fraud;
- Encouraging citizens to work, save and invest;
- The potential increase of tax revenues.

In sum, ***the flat-tax regime feeds economic growth through encouraging the production of capital and attracts foreign investments through the increase of the investment capacity in the economy. Moreover, it ensures the increase of budget revenues through an improved and effective tax administration system.***

Simultaneously, flat tax has negative effects due to:

- The elimination of the prospect for freeing disadvantaged groups from taxation (with the elimination of the clauses precluding taxation)
- Encourage inequality since the taxation is not progressive, therefore the rich would get richer and the poor would get poorer
- The elimination of the social policy dimension through the redistribution of income offered by the progressive taxation
- The uniform assessment of 'income' tax for individual activity (tax on wage) as well as for business activity (revenue tax).

Such a situation proves openly unfavorable for individuals, especially in countries with high rates of unemployment since, in such a case, labor is not paid fairly as a result of the overabundant supply and the limited demand.

Overall, ***the flat-tax regime accentuates social inequalities by shifting the attention from lightening the fiscal burden of individuals, and especially those with low and average income to lightening the fiscal burden for businesses.***

CHAPTER 2 THE REGIONAL FLAT TAX EXPERIENCES

Far from the populist philosophy of the political class which maintains that the flat tax is a simple way of reckoning the taxation level, the practical implementation of this reform in the region of Eastern Europe has proved to be, in fact, rather complex. Based on the experience of the 8 Eastern European countries where the flat-tax reforms have been implemented, fiscal adjustments and their effects on the business and investments milieu have been quite diverse in each State. Even the influence of such reforms on public revenues have shown different results: in some countries, the reforms were followed by an increase in tax revenues while, in others, they were followed by a decrease.

Table 1: Flat Tax Regimes in the Region

Country	Year	Personal Income Tax (PIT)			Corporate Tax (CT)			
		Before the Flat Tax	After the Flat Tax	Changes in the PIT revenues	Before the Flat Tax	After the Flat Tax	Changes in the CT revenues	Changes in the revenues from indirect taxes
Estonia	1994	16-33	26	↓	35	26	↓	↑
Lithuania	1994	18-33	33	↑	29	29	↓	Not changing
Latvia	1997	25 and 10	25	↑	25	25	↑	↓ Mild
Russia	2001	12-30	13	↑	30	37	↑	↓ Mild
Ukraine	2004	10-40	13	↓	30	25	↓	↑
Slovakia	2004	10-38	19	↓	25	19	↓	↑
Georgia	2005	12-20	12	↓	20	20	↑	↑
Romania	2005	18-40	16	↓	25	16	↓	↑
Montenegro	2007	16-24	15	↓	15/20	9	↓	Unknown
Macedonia	2007	15-24	12	↓	15	12	↓	Unknown

In addition, tax leveling, in its classical sense, has not been fully implemented, especially in regards to personal income tax since the increase of the fiscal burden on low wages is even more obvious. The threshold of wage taxation rose in the crushing majority of the flat tax countries, like Estonia, Lithuania, Ukraine, Russia and Romania. There were even cases where the threshold rose twofold, as in the case of Slovakia, with the purpose of reinforcing the protection of low income employees.

Another dominant trait, as far as flat tax implementation is concerned, is the tendency to accompany the tax reform with numerous supplementary changes of the taxation system in its totality. This regional flat tax trait might be considered one of the gravest deviations from the theory and philosophy of flat taxation.

Examples of the most important changes of the fiscal system include the introduction, for the first time, of capital profits, dividends and the increase in the level of excise. Meanwhile, some countries have completely eliminated incentive exceptions from determined taxes. Policymakers, in some cases, have even carried out artificial interventions so as to increase the taxable basis, like in the case of Russia, where the taxation system includes eliminating exceptions for military service officials.

An interesting example is brought to us by Montenegro. In December 2006, the Montenegrin Parliament approved a flat-tax regime of 15% for personal income taxes, which is expected to enter into force on July 1st, 2007. This regime will replace the past taxation system, in which personal income is subject to taxation according to the following three echelons: 16% for monthly income from 65 to 218 Euros, 20% for those from 216 to 381 Euros and 24% for income of more than 381 Euros per month. Meanwhile, as far as income tax is concerned, it will have a value of 9%, which will replace the previous systems of two norms, respectively 15% and 20%. The point of interest in the practical implementation of the flat-tax regime which is expected to take place soon in our neighboring country is that, as far as personal income tax is concerned, which will be lowered after this reform, public revenues will be safeguarded from amortization due to a system of gradual decrease in taxation. According to the careful planning of the Montenegrin policymakers, the personal income flat-tax will be set at 15% for the rest of 2007 and it will be lowered by 12% during 2008, while in 2009 and 2010 it will be at the same level with the income tax of 9%.

The Essence of the Flat Tax Intervention

The implementation of the flat tax in the region was mainly focused in the change of two main taxes: taxation of personal income and taxation of profit, as it is described in the theoretical models of flat taxation. However, there have been unique cases, such as in Slovakia, where the flat-tax reform has involved the Value Added Tax, which was seen more as an apparent tendency toward symmetry rather then a genuine economic policy.

However, the Personal Income Tax has suffered more essential changes, constituting therefore the crucial component in terms of changes caused by the implementation of the flat tax. From being a multiscaled system, in all cases the implementation of the flat-tax reform in the region has leveled the Personal Income Tax, by excluding determined border values before the start of taxation. In the earlier cases of flat tax implementation, in Estonia, Lithuania or Latvia, during the years 1994-97, policymakers chose high taxation levels from the existing progressive system, respectively 26%, 33% and 25%. Meanwhile, after the year 2000, other countries have accepted lower Income Tax rates, like 12% in Georgia and 19% in Slovakia while in the case of Corporate Tax, the region's experiences have shown that policymakers have been cautious.

For example, Lithuania, Latvia and Georgia have opted to leave the Tax on Profit unchanged when adopting the flat-tax reform, while Russia has applied an increase of 7%. Meanwhile, Estonia has made the boldest move on the Tax on Profit because it has lowered it by 9%, taking it to a level of 26%.

The lowest tax rate of 16% was applied by Romania. The caution of the region's policymakers in the leveling of taxation on corporates, or on profit, is justified if we take into consideration the drastic effects that such reform would have on the budget.

"Corrections" with other taxes

The most dominant trait of the flat-tax reform in the countries of the Central European region has been the intervention of policymakers in other tax systems, which has been generally one of tax increase. These interventions did not take into consideration the theoretical quintessence that guides the flat-tax philosophy: the single and unified taxation of income. On the contrary, they have encouraged double taxation, especially when introducing taxation on dividends and taxation on capital profit into the taxation scheme.

It is obvious that the interference of these taxes, guided by pragmatic reason more than principle, has been decisive in the amount of public revenues when this amount, before the reform, is compared with that of after the reform of the two taxes (tax on profit and personal income tax) within the context of the flat-tax reform. The cases of Russia and Slovakia illustrate clearly this reasoning.

An Increasing Effect on Tax Revenues

One of the most altered taxes during the flat-tax era in the Central Eastern European region was the Value Added Tax. The alterations and corrections it has suffered have had substancial effects on public revenues, since VAT is one of the main revenue sources for these budgets. Slovakia has increased VAT on food products from 14 to 20%, accompanied by a slight general decrease from 20 to 19%. Ukraine has eliminated the exceptions of VAT application in some economic sectors such as construction, the airplane and ship building industries. This measure was also applied in Georgia and Russia. The latter even included small businesses in the VAT scheme during the time of its reformation.

The increase of excise taxes was another popular tendency in the region during the implementation of the flat tax. This phenomenon was mostly blatant in Russia where the excise taxes were doubled, while there was an increase in excise taxes even in the cases of Lithuania, Romania and Georgia.

Taxation on other kinds of income has experienced an obvious growth in the case of Russia where dividend tax doubled from 15% to 30% while, in Ukraine, taxation on other kinds of income was raised by 13% during the flat-tax reform; additionally the capital profit tax had a more comprehensive increasing effect. Romania, on the other hand, during the wave of flat-tax fiscal reforms, increased its dividend tax level as well as its passive income tax. Taxation on other kinds of income was accompanied by some preferences and exceptions in the year 2003 and 2004 in Ukraine and later in Georgia.

A Decreasing Effect on Tax Revenues

Although this reform was publicized as being helpful for business and foreign investments, the implementation of the flat tax has caused, in a few cases, additional incentives which had a decreasing effect on taxes. An illustration of this point is Slovakia, which eliminated the 15% dividend tax as well as the taxes on gifts or inheritance. Additionally, Estonia eliminated dividend tax, while Latvia preserves a non-taxation policy for divideds and interest income. Meanwhile, Georgia's incentives include the lowering of the VAT from 20% to 18%.

Flat Tax Effect and its Repercussion on Revenues

After the first year of implementation of flat-tax changes on the household tax and income tax, the public revenue trend was not clearly oriented towards either increase or decrease.

After replacing progressive personal income taxation with flat taxation, some countries have manifested a positive growth in public revenues, such as Lithuania and Latvia, where the level of personal income taxes has been one of the highest, at the rate of 33% and 25%. On the other hand, in countries such as Ukraine, Slovakia, Georgia and Romania, public revenue levels after the implementation of this tax was negative due to the fact that income levels had decreased. These countries have taken a risk by applying a lower taxation level from 12% to 19%. Russia has gathered more revenues from personal income, but this achievement was compromised due to the strain caused by the insertion of taxation on military personnel into the taxation scheme, which instantly caused an artificial increase in state public revenues.

In the meantime, the situation with the corporate tax reform is clearer. All the countries (Estonia, Ukraine, Slovakia and Romania) that have proceeded to a lowering of corporate tax have suffered loss in public revenues. As one would expect, the increase in corporate tax in the case of Russia has brought about an increase in public revenues while Lithuania has suffered a loss in tax revenues even though the level of corporate tax remained unaltered.

The most visible growth trend of public revenues is considered to be mainly related to indirect taxes. The crushing majority of countries in the region which have applied the flat tax have experienced an increase of revenues from indirect taxation. Meanwhile, only Russia and Latvia have suffered a mild decrease of these revenues. Indirect taxes have also contributed the most in the absolute value of the budget, even more than other direct taxes like income tax and household tax. This fact is supportive of the *thesis according to which a part of the success of revenue growth following the implementation of a flat tax can be attributed to the increase of indirect taxes and not of those which are the focus of the flat-tax reform.*

Europe only Considers the 'Rhetorics of the Flat Tax'

The flat tax experiment and the return to the old theories of flat taxation has been an utterly eastern phenomenon during the last years. As we know, no Western European country has applied a flat-tax system.

The European Commission's official stance has made no reference to any general orientation of the fiscal system. The European Commission believes that there is no need for a harmonization of the fiscal systems of the EU member states. Thus, the Commission respects the decisions of the member States in regards to the adoption of their tax systems. [3]

Public debates have been held in Germany regarding the possibility of the flat tax implementation. Thus, the former advisor of the German government, **Wolfgang Wiegard** declared that the proposals for a flat-tax level on income and corporate profits would increase investments in the largest European economy. Wiegard was even one of the members of a panel which devised a concrete plan for the German Minister of Finance in 2004. This plan involved Germany to adopt a flat tax of 30% for personal income and corporate income. The German Chancellor Angela Merkel had also proposed a flat tax before the September 2005 elections. However, she withdrew her idea at the last moment. The main advocate of the flat tax in Merkel's CDU party, Pol Kirchhof described the scheme as, "Each person has only 25 cents out of any euro they earn. With the rest of the money they are free in the garden of freedom". Mr. Kirchhof resigned from his post as shadow Finance Minister after the elections, since the majority of the negative electoral results of the CDU had his flat-tax theory as their basis.

Even Spain has discussed the implementation of a 30% level of taxation during the last socialist government. Miguel Sebastian, brought this idea to public attention but it never saw concrete realization.

In Great Britain, the shadow Prime Minister of the Tories, George Osborne, had raised a commission to study the idea of a flat-tax regime. Furthermore, the soon to be Labor Prime Minister of the United Kingdom, Gordon Brown, is renowned for his enthusiasm in regards to flat taxation. Despite this public support, the United Kingdom has not taken any executive step towards any actual realization of the flat-tax philosophy.

Poland had planned to present concrete proposals on the flat tax at the beginning of 2007. However, after the September 2005 elections, a compromise plan was devised, which ensured victory for the Party for Law and Justice and their followers of the Civil Platform. The aim of the latter was to present a 15% flat rate tax.

According to the former Prime Minister of Hungary, Viktor Orbán, the current leader of the main opposition party FIDESZ-MPP, Budapest will have 'no other solution' than to turn to the 'victorious flat tax' so as to preserve the country's competitiveness and to

[3] COM (2001) 260, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: *Tax policy in the European Union - Priorities for the years ahead.*

keep a fair rate of foreign investment. However, the Minister of Economic Affairs, János Kóka declared that for the time being, Hungary 'prefers not to follow the trend'.

The Prime Minister of the Czech Republic, Stanislav Gross has also expressed his favor for a simplified taxation system. However, when he declared that the level of economic growth was the double of the average Eurozone value, he also added that Prague will not introduce the flat rate tax.

Researchers have expressed positive and negative stances in regard to flat taxation. The president of the Adam Smith Institute, Madsen Pirie has declared that "The UK's economic cost in not applying the flat tax, in terms of the denied growth and of all the wasted efforts of the administration, reach billions of pounds every year, maybe 10 billion." The liberals in this institute declare that the flat tax is a timely idea, which bears extraordinary advantages for its supporters.

On the other hand, the Center for Policy Studies (CPS) has argued that, "The flat tax, even though it is a remedy for all maladies, will not be able to solve the complex issue in itself." The Center for Policy Studies believes that a fast and sudden lowering of taxes might ignite the spark of "an immediate and even critical downfall which would severely undermine credibility in economy." [4]

[4] Martin, D., *An overview of the flat tax*, Centre for Policy Studies, London September 2005, pg.4.

CHAPTER 3 FLAT TAX IN ALBANIA

Flat Tax is being proposed in Albania, in the same way as in the countries of the region. Mainly, after the essential changes, the focus has been on personal income tax and income tax. Until now the government has not made clear its will to change the income tax, as well as the dividends, for which the tax rate is currently 10%.

One of the foremost differences from the regional countries' experiences is the chosen 10% level of taxation, which is one of the lowest levels ever applied. Meanwhile, in a unique effort compared to the region, the Albanian government has decided to undertake other parallel fiscal reforms, such as the initiative for the categorization of detailed reference wages, in order to calculate taxation. If that will be implemented without any problems, it will directly influence the results of the flat tax. If we link this to the explanation made in the first chapter, the flat-tax reform modifies the norms of taxation, while the categorization of wages directly affects the basis of its application. Each of these experts in the field of public finance has attempted to avoid the confrontation with these two challenging dimensions as it acutely increases risk for public revenues.

The Dimension of Fiscal Changes on Public Revenues

In order to understand the dimension of the fiscal changes in the context of the flat tax, we must first investigate the weight that income tax and personal income tax have on public revenues.

The Mid-Term Budgetary Framework for the period 2007-2009 foresees that during the year 2008, the total amount of tax revenues in the budget will reach the sum of 260.6 billion lek, or 24.2% of the Gross Domestic Product (GDP). The revenue forecast in the Mid-Term Budgetary Framework for 2007-2009, according to the Ministry of Finance, was made taking into consideration a gradual lowering of the tax levels of income tax from a present 20% rate (before the entering into force of the flat tax) to a 17% rate in 2009.

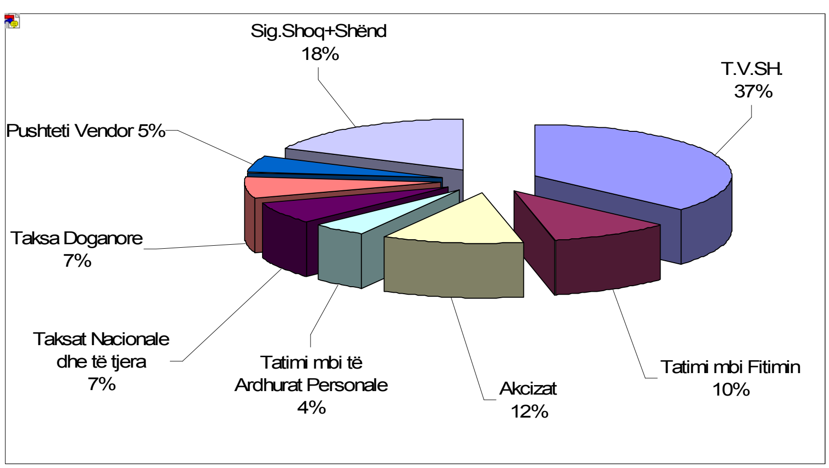
Table 2: Forecast for Revenues during 2005 – 2009 (in millions of lek)

	2005	2006	2007 Budget	2008 Forecast	2009 Forecast
TOTAL REVENUES	204,163	229,932	253,795	287,900	321,229
I. Aid	6,168	6,000	6,386	8,606	9,413
II. Total of Tax Revenues	183,816	207,400	229,989	260,653	291,962
II. 1. From Taxation dhe Customs	135,605	159,000	173,975	192,936	212,429
1. V.A.T	64,534	76,000	85,400	92,765	101,412
2. Income Tax	19,237	21,000	22,900	24,663	27,428
3. Excises	18,523	24,200	27,029	30,567	34,254
4. Personal Income Tax	7,402	9,000	10,800	15,490	18,120
5. National and Other Taxes	12,281	14,600	16,041	17,645	19,410
6. Custom Duties	13,629	14,200	11,805	11,805	11,805
II. 2 Local Government Revenues	12,019	11,100	13,214	14,698	16,985
1. Small Business Tax	3,793	2,500	2,690	2,920	3,212
2. Local Tax	8,226	8,600	8,383	11,778	13,774
III. Contributions of the Social and Health Insurances	36,192	37,300	38,263	53,020	62547
IV. Non Taxation Revenues	14,178	16,532	17,420	18,642	19,854

Source: Mid-Term Budgetary Framework 2007-2009

The figures make it clear that the consumption taxes (V.A.T + excise + custom duties) will be the dominant source of revenue for the Albanian budget, reaching 56% of the total amount. Meanwhile the taxes which will be at the focus the flat-tax reform, personal income tax and corporate tax, together make up only 14% of the total budget revenues.

Chart 1: The Structure of Tax Revenues as reflected in the budget for 2006



Source: Ministry of Finances 2007-2009

Personal Income Tax

Personal Income Tax, in the context of the flat-tax reform, simplifies the steps but does not eliminate them, as we can see from the following table. From a calculation system of a five-row table we will have a system with two rows less. As we saw from the examples of other countries in the region as well as in the Hall-Rabushka theoretical model, there is a tendency in softening the effects of the flat tax on individuals with low income by putting 10 thousand lek as the 0 taxation limit, which is not relevant neither to the reality of minimum wages, nor to any of the recent wage categorizations. For annually wages up to 30 thousand lek, each wage above the limit level will be subject to a 10% tax, thus 20 thousand lek, at minimum, will be subject to taxation for the maximum wage within the echelon of 30 thousand lek. All monthly wages that exeed 30 thousand lek will be subject to a 10% flat tax.

Table 3: Personal Employment Income Tax (progressive variant)

Taxable monthly income		Personal Employment Income Taxation
0	Till 14,000	1%
14,001	40,000	140 LEK plus 5% of the amount over 14,000
40,001	90,000	1,440 LEK plus 10% of the amount over 40,000
90,001	200,000	6,440 LEK plus 15% of the amount over 90,000
200,001	more	22,940 LEK plus 20% of the amount over 200,000

Table 4: Personal Employment Income Tax (flat-tax variant)

Taxable monthly income		Personal Employment Income Taxation
0	Till 10.000	0%
10.001	30.000	+ 10% of the amount over 10.000 lekë
30.001	more	10% of the amount over 0 lekë

A simple analysis of the effect of the change in personal income tax on individuals will deduce that the implementation of this fiscal change increases the level of taxation in absolute terms for wages until 140 thousand lek per month. At the same time, for wages above 140 thousand lek, personal income tax suffers a decrease compared to the current progressive system. This means that individuals with lower and medium income will be subject to an increase in income taxes and consequently will have less net money for consumption. On the other hand, those with higher wages will benefit from the lowering of their income tax and, consequently, will have more net money for savings.

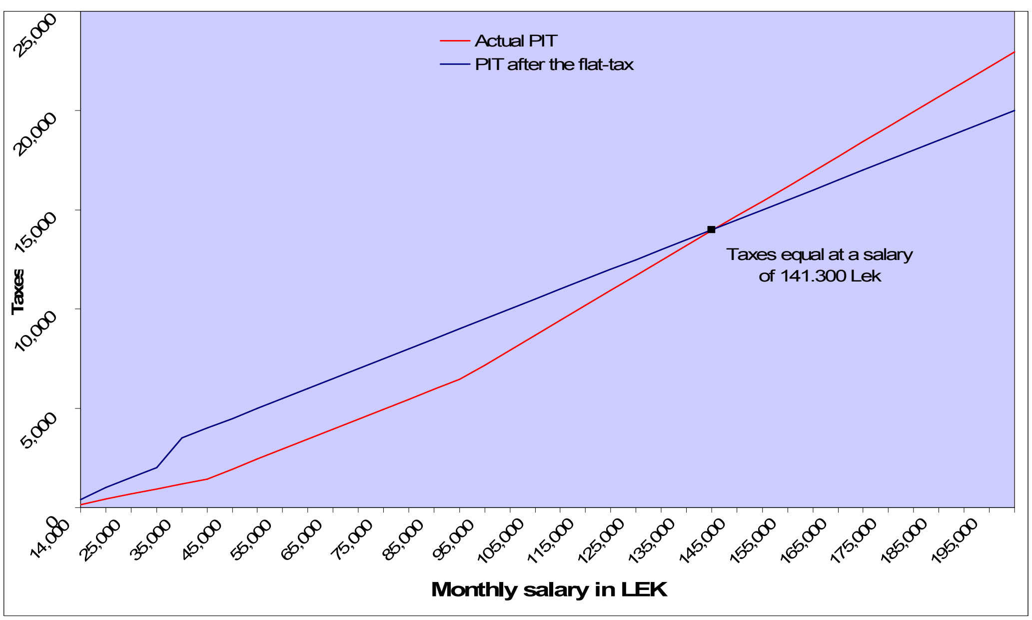
Tabela 5: The Flat Tax Effect on the Monthly Income of Individuals

Monthly wage	Difference in income between the current variant and the flat tax variant
17.000	**-410**
30.000	**-1.060**
40.000 - 90.000	**-2.560**
100.000	**-2.060**
200.000	**2.940**

Source: AGENDA Institute

Meanwhile, the medium income population layer, included in the segment from 40.000 to 90.000 lek per month will suffer the most severe net damage of this proposed reform, with 2.560 less income after the implementation of the flat tax. This issue is of vital concern as it augments the further stratification of the population, where "the richer will get richer and the poorer will get poorer". In addition it is of interest to the theoretical approach of its implementation and its chances of success. The diminishing of the net amount of money for the low and medium strata has a direct effect on aggregate demand in the market since these two consumer categories are the so-called 'mass consumers'. As we discussed above, our system of tax revenues is strongly based on consumtion taxes which would directly be affected by a decrease of the market's aggregate demand.

Chart 2: The value of Personal Income Tax (PIT) from employment, according to the level of monthly salaries



Source: AGENDA Institute

When estimating the flat-tax effect in its dimension of personal income and their weight on the public revenues, we must understand the structure of collecting these revenues. However, the following table will give only a general idea of the situation as any attempt at calculation would be merely speculative. The reason for this scepticizm is closely related to the fact that, in order to be accurate, we must calculate the effects of both reforms which will be implemented almost simultaneously in the fiscal system: that of the flat tax and that of wage categorization. The latter hinders us from determining an exact numerical value to its dynamic effect since we are convinced when saying that business will surely find alternative ways to avoid the implementation of wage categorization – a reform the logic of which is anti-economic.

Table 6: The Structure of State Revenues based on Personal Income Tax*

	2001	2002	2003	2004	2005	2006
From employees of the public sector	31.43%	29.31%	33.08%	32.32%	30.07%	29.62%
From employees of the private sector	12.36%	16.54%	12.27%	13.06%	17.42%	20.56%
From Dividends	16.80%	6.86%	5.86%	4.81%	5.02%	5.15%

Source: General Directorate of Taxation, elaborated from AGENDA Institute

**The table presents only the structure of revenues from the wages and dividends, which make up 55.3% of the total revenues from income tax. The rest is made up of revenues from the bank deposit interests. Source: Directory of Taxation*

Based on the table above, the implementation of a flat income tax will have a positive effect on public employees, who contribute about 30% of the amount of revenues collected by income tax. Based on our estimations, the expected average monthly wage for public sector employees in the following year will be 31 thousand lek. The calculations below show that this section alone will increase public revenues by 1.7 billion lek. If this component was 30% of the total income tax revenues, then we could conclude that after the implementation of the flat tax in 2008, the State would be able to collect 5.8 billion lek more than the year 2006, which is only 10% of the difference between the total revenues forecasted for 2008 and the revenues collected during 2006. (According to Table 2)

Table 7: The minimum effect of the flat tax on public sector employees

The expected average monthly wage for public employees in 2008	Tax (10% for 21,000 lekë)	Annual Taxation for 1 employee	Annual Income Tax Tatimi for 170 thousand employees	2006 budget revenues from public sector employees	Positive effect of the flat tax on the state budget
31,000	2,100	25,200	4,080,000,000	2,541,999,000	1,742,001,000

Estimating the effects of this tax on employees from the private sector is significantly more complex. Based on the data published by the General Tax Directory, the effect of personal income tax on private employees is about 21% of the total public revenues from income tax. This level strikes specialists as not accurate in regards to the private sector, which is also the motor of the country's economic growth. However, as we have mentioned before, the flat tax is not the only intervention of a fiscal nature that the private sector will suffer in regards to personal income or wages.

The application of minimum reference wages, based on a detailed scheme is expected to cause immense alterations in the declaration of wages on the part of the private sector. Companies will have to face this initiative's string of consequences, which include not only an increase of the absolute value of contributions for social and health insurance schemes, but also the pressure that is expected to emerge from another direction. The employees, who will prefer not to declare their employment status rather then have the State collect income tax and insurance at the source of payment when, paradoxically, the government's decision does not guarantee them receiving that amount in the first place.

<u>Income Tax</u>

Income tax, which was a flat tax of 20%, has been cut in half, thus, making it the boldest aspect of the flat-tax reform and which is expected to result in the biggest losses for the budget. Policymakers have argued that they expect the drastic cut of income tax to reflect the effects of the Laffer Curve, which supports the idea that cutting the level of taxation increases public revenues. However, as we clarified in the first chapter, such an effect is only possible when the present tax situation is situated on the right side of the optimal taxation level of the t* value.

The discussion in regards to how an economy must be positioned in Laffer's chart is a thorny issue and will not give an accurate estimation, as Dr. Laffer himself has affirmed that his chart serves more to academia rather than policymakers. However, if we make an analysis based on the exception, it is rather obvious that our country's economy can in no way be located on the right side of the t* value, for as long as our aggregate level of taxation, expressed in the ratio between the amount of public revenues and the GDP, is situated at such a low point. The Mid-Term Budgetary Framework for 2007-2009 forecasts that in 2008, the total of tax revenues in the budget will amount to 260.6 billion lek, or 24.2% of the GDP[5], while the average amount of the Western Balkans region was 40.7% in the year 2003. [6] Therefore, there are few chances that the Laffer Curve will be able to theoretically support an increase in public revenues as a result of tax cuts in the case of Albania.

Since the theoretical approach allows us to consider the flat-tax reform's failure in increasing revenues more than its success, we will again rely on figures. We can attempt at estimating the effect that the 10% flat tax will have on income tax, based on the figures found in the forecast of public revenues in the Mid-Term Budgetary Framework.

[5] Banka e Shqipërisë, *Raporti Vjetor 2006*, fq. 55.
[6] CEPS *Europa South-East Monitor*, Issue 51, January 2004, European Commission, Directorate-General for Economic and Financial Affairs.

The estimations in the Mid-Term Budget Forecasts (MTBF) table have relied on a drop of 3 points of percentage (from 20% to 17%), thus, we must estimate only the effect that the unforecasted drop from 17% to 10% will have on the PBA.. We must underline that the MTBF table has also taken into account the positive effects that will result from an efficient taxation management, the reduction of 'informal' economy and fiscal evasion. 7 Since all these positive effects have been estimated in their utmost outcome, we can allow ourselves, for the sake of our analysis, to calculate only the effect of lowering the taxation level by 41% (always from 17 to 10%).

Table 8: The linear effects of lowering the income tax to the level of 10%

	Expected revenues in the 2008 budget (mln lek)	Unexpected changes in the MBF (the cut from 17% to 10%)	Decrease/Effect (mln lekë)
Income Tax	24,663	Drops by 41%	10,111

The tax "correction" scheme

Reference wages are only one of the various aspects of the flat tax which are "corrected", with an anticiapted strong effect on the budget revenues. As the Albanian government races to follow the examples of countries in the region, it has increased the excise tax on several products, such as alcoholic drinks and some fuels, including the plan for increasing custom tariffs for some products which break away from WTO or EC regulations, such as is the case for used automobiles.

With the intention of relating these estimations, which are not highly professional but quite comprehensive nonetheless, we can conclude as follows. With the flat-tax reform proposal, which focuses on the income produced from wages and from income, the Albanian State, in 2008 will have collected about 5.8 billion lek more in its budget compared with 2006, due to the increase in income tax from employment. However, the budget will also suffer a 10 billion lek less than the forecast one, due to the lowering of income tax.

[7] PBA 2007-2009, fq 8.

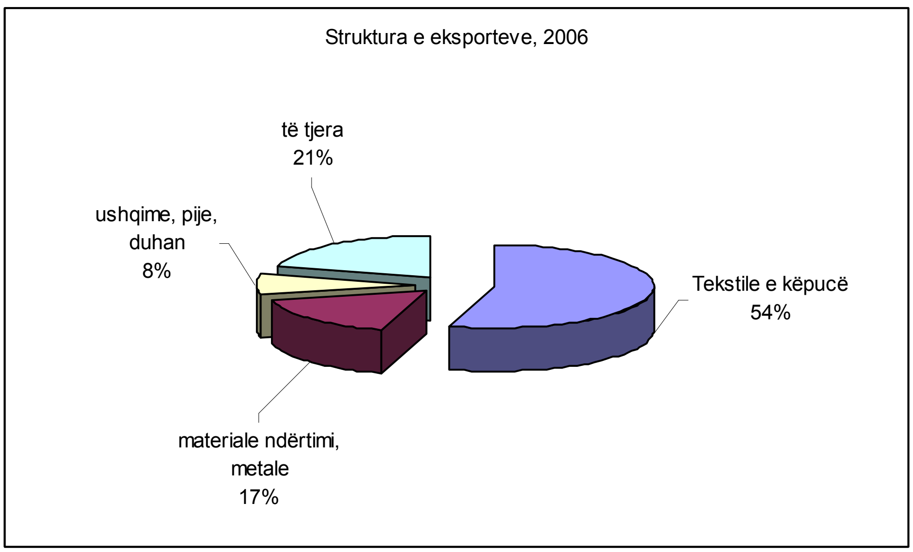
CASE STUDY

THE FLAT-TAX EFFECT IN THE TEXTILE AND SHOE INDUSTRY

An introduction to the textile and shoe industry

The textile and shoes industry is of considerable weight in the country's economy, especially in the contexts of exports. In 2006, textile and shoes exports made up 54% of the total amount of exports, and about 5% of the country's GDP.

Chart 3: The Structure of Exports, 2006

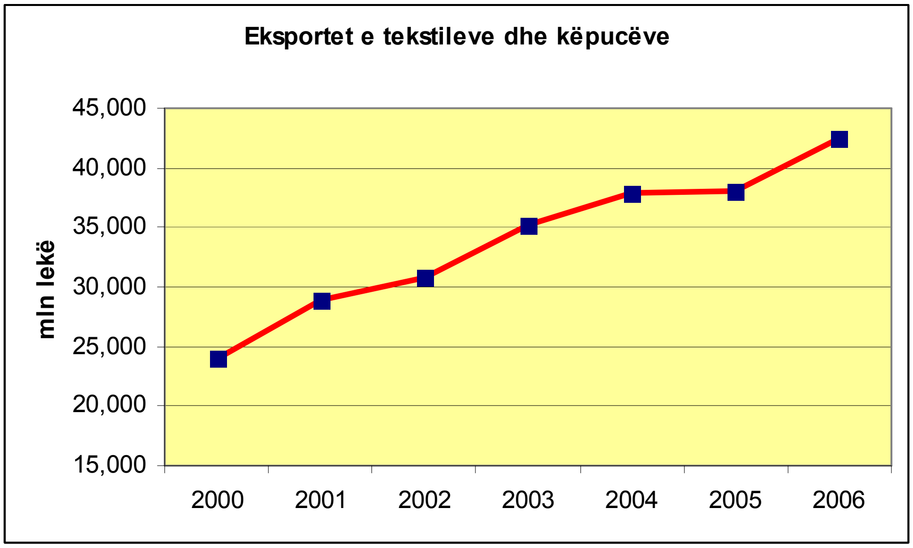


Source: INSTAT, Foreign Trade Situation, December 2006

This industry is organized based on a system of ordering materials for foreign markets (inward procesing), where 70% of the production is exported to Italy and the rest to Greece and other EU countries. It is an industry that is intensly based on labor force and since the 1990s it has exploited cheap labor.

During the year 2005, the textile and shoes industry was faced with Chinese competition, as a result of the decrease in orders from EU partners, which was a result of the invasion of cheap Chinese goods towards EU countries (this was a result of the removal of EU quotas). The industry managed to get back on its feet during 2006, following the temporary embargo that the EU countries set against China. This embargo is expected to come to a close in the end of 2007. Consequently, the industry will again in 2008 have to face highly competitive pressure.

Chart 4: Expots of textiles and shoes



Burimi: INSTAT

The situation was positive during the first trimester of 2007, when textile and shoes exports have grown by about 17%.

The Effects of the Latest Changes in Industry

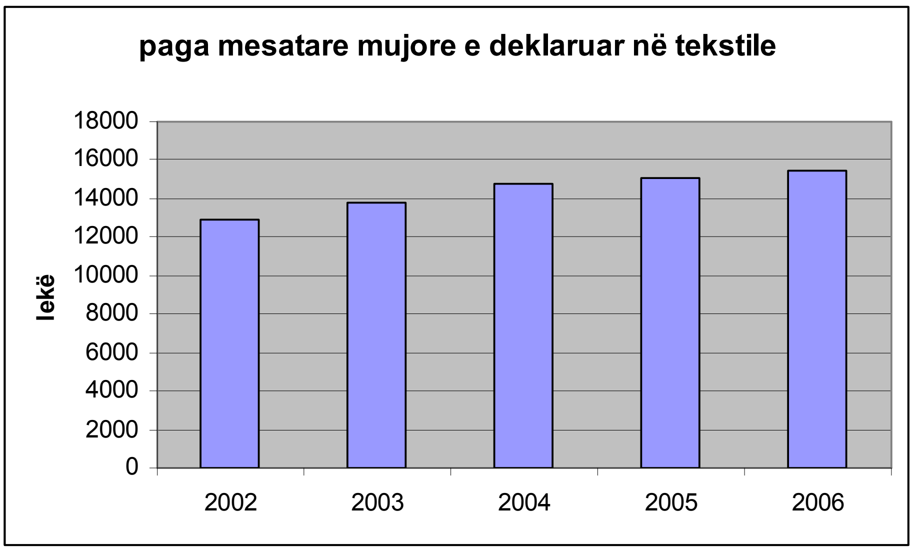
According to the INSTAT structural survey, during 2005, the textile and shoes industry's gross profit has amounted to about 1.1 billion lek. (2005 is the most recent year for which INSTAT has any data). In addition, it has paid an income tax of about 210 million lek. Based on these data, one can conclude that with the reduction of income tax from 20% to 10% in the context of the flat tax, the industry will be making a maximum profit of 100 million lek per year.

What was expected to have the most positive effect in encouraging this industry, was an expected decrease in the social insurance contributions made by the employer. Firstly, the government declared that, in the framework of the flat tax, the percentage of insurace costs to be paid by the employer would decrease from 21.7% to 10%. Such an action was not carried out.

In addition, the industry would also benefit from the increase in the minimum wages that would be used as a reference for the estimations of social insurance, in the context of the Decision of the Council of Ministers, No. 285, date 4.5.2007 "On determining the minimal monthly reference wage, with the aim of estimating the social and health insurance contributions, as well as of the personal income tax, based on the nomenclature of economic activity for the non-public employees, that work in unqualified or qualified jobs, as well as for their management and techincal and economical personnel."

This decision will significantly increase the minimal wage which will serve as the basis for insurance payments from this industry. For unqualified workers, the minimal wage in Tirana (where there are numerous factories) will amount to 17.000 lek, while the current wage is 14.000 lek. Meanwhile, for qualified employees, the wage will increase to 26.000 lek from present wage of 15.000-18.000 lek. Thus, we have an average increase of the minimal wage of 20-40%, which will contribute in increasing the cost of labor in this industry. This immediate increase of the minimal wage is in utter contrast with the tendency of the recent years, when minimal raises in average wage have been applied (for example, in the year 2006 the reported average wage, according to INSTAT increased by only 2%, compared to 2005).

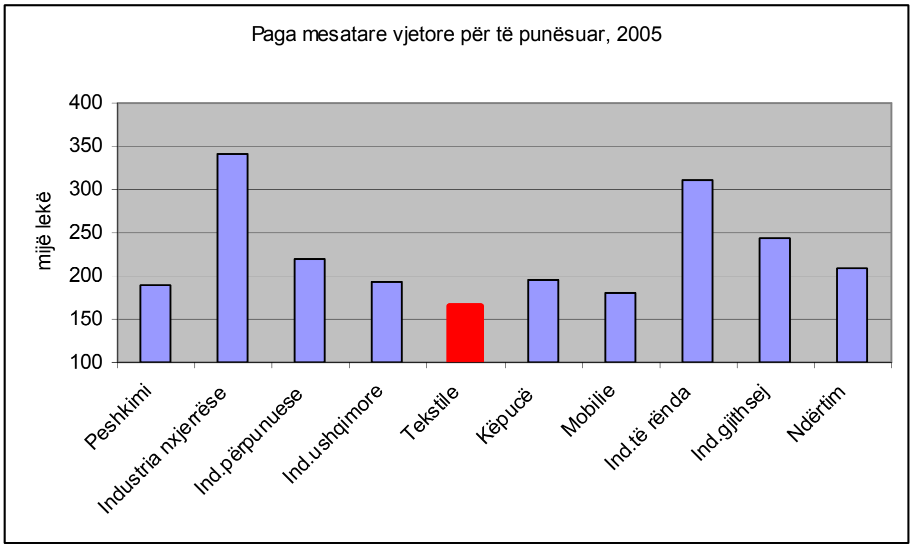
Chart 5: Average monthly wage declared in textiles



Source: INSTAT Factories' Structural Survey, 2002-2005;
2006-Industry's declarations

On the other hand, according to INSTAT, the textile sector has declared the lowest annual average wage for employees, when compared to all the other industry sectors. This is a result of the low level of qualification of the employees in this sector, about 40% lower than the average of the industry. The declared wages in the shoe industry are somewhat of a higher level.

Chart 6: Average monthly wage for employed, 2005



Source: INSTAT, Structural Survey 2005

Despite this fact, the government's decision about setting reference wages in the private sector puts the textile industry at the same level as other industries. Therefore, they have equal reference wages to the heavy industry or the construction industry, which in reality have much higher wages.

The effects of the reference wage's increase

The following table presents us with an approximate estimation of the added costs that this industry will suffer as a result of the increase of the minimal cost, due to the minimal wages' increase.

Table 9: Preleminary cast of the cots of reference wages in industry

	Monthy insurance for one employee	Monthly insurance for 20,000 employees	Annual Insurance for 20,000 employees	Added costs for the industry compared to scenario 1
Scenario 1 minimum wage 14,000 lek	3038	60760000	729120000	
Scenario 2 minimum wage 18,000 lek	3906	78120000	937440000	208320000
Scenario 3 (min. wage 18,000 lek, but insurance percentage decreases at 10%)	1800	36000000	432000000	-297120000

The table shows us that, in the second scenario, the industry would have to pay 200 million lek more than in the current situation which is double the amount than the one which would be saved from the lowering income tax. Accordingly, the industry will be facing a total added cost (negative effect) of about 100 million lek per year (which is about 12% of the net profit).

Meanwhile, in the case when the insurance percentage would have decreased to the level of 10%, the industry would have positive effects on the cost, despite the increase of the minimum wages, due to insurance payments. The positive effect, including reserves produced from the cut in income tax would be about 400 million lek (about 50% of the net profit). In fact, the representatives of this industry have repeatedly demanded a further decrease of insurance contributions, as an incentive for industry.

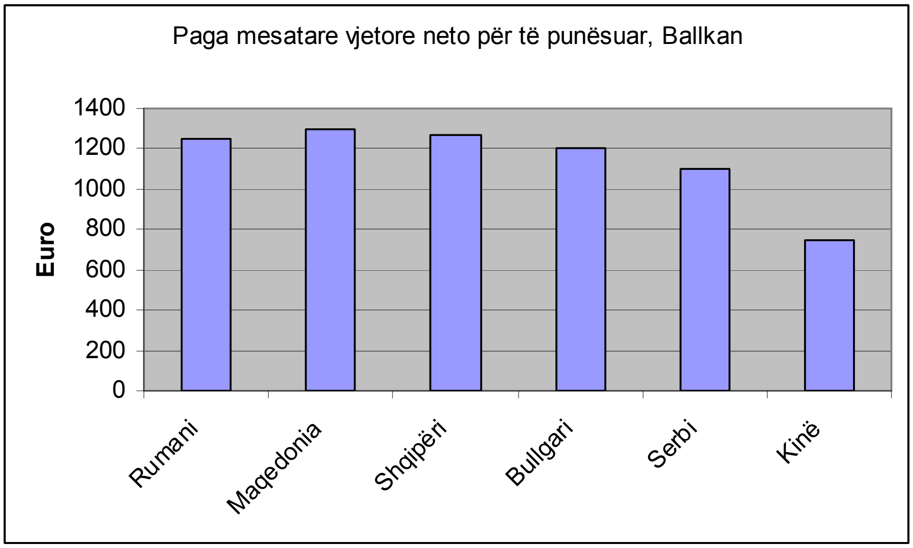
The dangers of increasing the cost of labor in the textile industry

The textile and shoe industry is characterized by these features:

- Firstly, it is a labor intensive sector
- Secondly, this industry has a low labor cost, which is an essential competitive advantage
- Thirdly, the industry is completely dependant on foreign contractors and has a fixed cost of materials and sale prices, which are determined by foreign partners. Therefore, the industry is unable to respond to an increase in labor force cost, whereas other industries would be able to respond, for example, increasing prices
- Fourthly, it is the industry with the highest rate of personnel expenditures to turnover, compared with all other sectors of economy. According to INSTAT, this ration is about 35% while, according to the representatives of this industry themselves the ratio is about 75%.

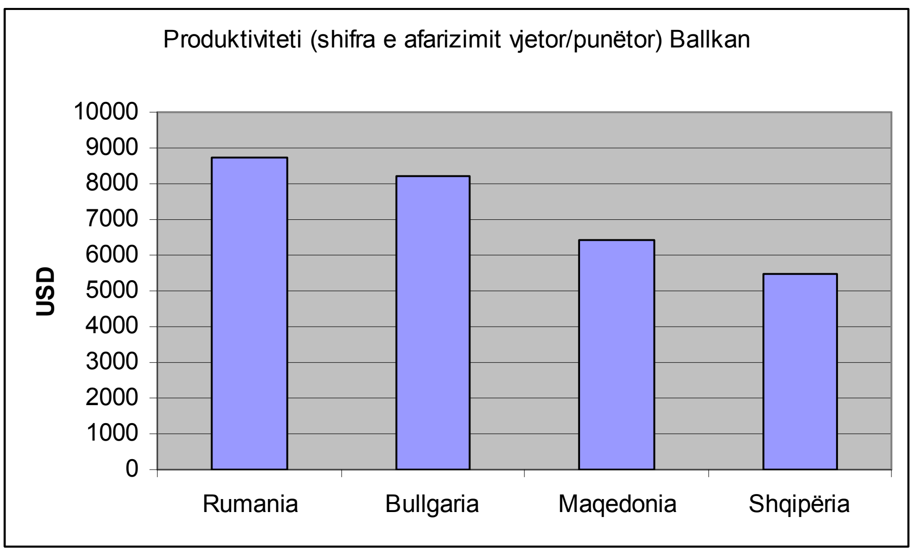
Consequently, a further increase in the cost of labor force will negatively affect this sector by weakening its competitive advantage of cheap labor. At present, Albania has a higher cost of labor force when compared to other countries in the region, while, at the same time, it has the lowest performance rate per employee.

Chart 7: Average monthly net salary for employed, the Balkans



Source: Statistical Reports of Respective Countries

Chart 8: Productivity (annual turn over/employee) Balkans



Source: Statistical Reports of Respective Countries

In sum, *such* a situation, when at the beginning of 2008, the European textile industry will be confronted with a growing competition from China, resulting from the removal of temporary quotas, the Albanian textile and shoes industry will have to face regional competitive pressures which will also be burdened by the most recent fiscal policies of the government. The latter will directly influence the weakening of this sector's competitiveness. In a chain reaction pattern, the weakening of competitiveness will lower foreign investors' desire to come to Albania and might even cause the departure of those who are already present in the country. Bearing in mind the heavy weight that the textile and shoes industry in exports, the commercial balance of the country will also be affected negatively.

Furthermore, an increase in labor force costs, which will increase the total production cost, does not seem an encouragment for business owners to declare the real number of employees so as to include them in the insurance scheme. The official number of employees in this sector is about 20 thousand, while the experts' estimate that this number might reach about 100 thousand employees should the government implement adequate policies towards employees' declaration.

INSTEAD OF CONCLUSIONS

Based on the regional flat-tax practices, either successful or unsuccessful, and taking account of western skepticism on the flat-tax, it can be concluded that this kind of policy reform does not guarantee explicit positive results. These experiences indicate that a significant number of countries have had to deal with revenue deficits. If exhaustively and accurately implemented, the flat-tax reform results in multifaceted effects, which, depending on the specific economic environment where it is applied, can either promote or undermine outcomes of social and economic policies.

The flat-tax reform is believed to support economic growth through the amplification of investing potential in the economy by stimulating capital generation and absorbing foreign investments. On the other hand, flat-tax regimes directly deepen wealth inequalities and enhance the stratification trends of the society through the elimination of fiscal favoring based on the level of income, as well as through the shifting of revenue collection precedence from profit-making entities towards the workforce. The overall results of both, predominantly influence upon the low and middle income individuals.

Throughout this modest study on the proposed flat-tax reform in Albania, attempts have been made to show that this kind of fiscal policy poses a craggy challenge with many uncertainties. One uncertainty relates to the issue of how this fiscal reform will affect the incentives of doing business on one side, and labor on the other. The effects on this equilibrium are determinant for the success of any policy to be implemented in the surroundings of a functional market economy and democracy. Other uncertainties arise in regards to how this reform will correlate with the formalization of hidden economic activity, tax administration efficiency or even on how the whole Albanian economic system will translate these changes in terms of employment, exports, foreign direct investments etc.

Taking reference of the latest policy attempts and taking into consideration the particularities of the Albanian economy, more effective than decreasing the corporate tax level would have been focusing on structural interventions necessary to create a more favorable and sustainable business environment. It appears that policymakers have decided to take the risk of decreasing the net income of individuals to favor capital creation through cutting corporate taxes in half. The estimations in this study indicate that the state budget will benefit an additional 5,8 bilion leks in 2008 due to the application of the flat tax on personal income, while it will suffer a shortfall of more than 10 billion leks due to the lowering of the corporate tax. But how sure are we that this additional capital will be transformed into investments, for as long as there seems to be a rather hostile business climate as well as a lack of consideration and willingness for improving it? It is not very difficult to agree that the latest policy practices do not offer the best example in this direction.

Regarding the labor market, the component that was expected to stimulate job creation and to expand the number of social security contributors was the initially announced measure of reducing the rate of social insurance contributions to be paid by the corporations. This rate was anticipated to decrease from 21.7 to 10% and it was originally part of the flat-tax package of reforms. This was actually the only aspect of the flat tax that conquered the support of some of the international financial institutions.

The reason for withdrawing such a measure was never explained but perhaps it might be related to the fact that in the first quarter of 2007, only 91% of the planned revenue collection from social insurance contributions was attained.

In terms of absolute value, the revenue collected in the first trimester of 2007 has decreased by 6%, from 8.6 in 8.1 billion leks, compared to the first trimester of 2006 when the corporate social insurance rate of contribution was 41.9%. Perhaps, even in the case of the previous decrease in the rate of social security contributions with 10 percentage points, the effects on government revenues was either inconsistently estimated or it was not assessed at all. For as long as the culture of preliminary debating and impact assessment of introduced economic policies has not yet matured, alarming exclamations by analysts and researchers will be inevitably present.

The final aim of this paper was not to offer an accurate calculation of the costs of flat-tax reform on the Albanian economy. Through presenting the theoretical framework behind the flat tax, an overview of the regional experiences, and a simplistic endeavor of calculating the public finance consequences of this proposal, the paper attempted to offer an overall assessment of the proposal for implementing a flat-tax policy in Albania. What indeed was the modest aim of this analytical study was to clearly articulate that the Albanian market has matured its diagnostic capacities and is not only able to understand these type of calculations, but it can even attempt to supply them on its own in the cases when important economic policies are not complemented by such cost-benefit assessments. This approach is essential not only for ensuring the consistency of proposed policies but also for increasing the confidence in institutions. The latter is believed to be the most successful treatment in the combat against those fundamental diseases that hamper the development of our society: corruption and informality.

However craggy the interventions with economic policies might appear to be, the prospects are in the favor of their success if and only if their ultimate outcome leans toward the creation of more job opportunities.

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http://www.euractiv.com; European Union Information Website

http://www.cer.org.uk; Centre for European Reform

http://www.ceps.be/index3.php; Centre for European Policy Studies

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