The Flat Tax : recent debates

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In essence the proposal for a "flat tax" is a simple one: that the income tax system should charge one marginal rate of tax on all income. Under the current tax system in this country, and many others, the rate of tax charged rises in a series of steps in line with one's income. In recent years several central and eastern European countries have introduced flat taxes – for example, in 2004 Slovakia imposed a 19% tax on personal and corporate income. Interest in a flat tax has also been encouraged by the appointment in January 2005 by President George Bush of a panel to consider reform of the US tax code; while the final report of the Advisory Panel on Federal Tax Reform made a series of recommendations to simplify the American tax system, it did not advocate this type of reform.[1] This note looks at the experience some countries have had with flat taxes, and the recent debate in this country about their merits.

In many ways the current debate about flat taxes mirrors an earlier one in the mid-1990s, sparked off by the campaign of the American millionaire Steve Forbes to obtain the Republican presidential nomination in early 1996. Further details are given in a second Library note.[2]

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A. The introduction of flat taxes

Over the past twenty years there has been an academic debate about the attractions in reforming the traditional structure of income taxes, replacing a schedule of rates, as can be seen across EU Member States and in the United States, with a single, flat rate. Proponents of 'flat taxes' have argued that charging tax at a single rate for all taxpayers would have several benefits, specifically, for tax administration, tax compliance and work incentives. Nine eastern European countries, from Estonia in 1994 to Romania and Georgia in 2005, have introduced low, flat rates on personal income and often equally low corporate taxes. In

[1] The final report was published in November ("Panel urges big cut in mortgage deduction", *New York Times*, 2 November 2005); the Panel's work is collated at http://www.taxreformpanel.gov/

[2] "The Flat Tax : debates in the mid-1990s", Library standard note SN/BT/28, 3 June 2005

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some of these countries, these reforms in personal taxation have been associated with a much stronger performance across the economy.

In an editorial in April 2005 the *Economist* observed "an old idea that for decades elicited the response, 'fine in theory, just not practical in the real world,' seems to be working as well in practice as it does on the blackboard."[3] Some economists might be surprised to discover that flat taxes have been shown to work on the blackboard in such definitive fashion. Nevertheless, it is important to underline that there is considerable variety in both theoretical flat tax models and how they have been implemented on the ground. As Jeffrey Owens, Director of the Centre for Tax Policy and Administration at the OECD, has noted, "there are many myths and misconceptions that surround the flat tax debate." In a presentation in November 2004 on trends in tax reform across the OECD, Mr Owens argued that there were three different types of flat taxes:

- Single rate, no allowance: All (positive) income is taxed at a flat rate.
- Single rate, basic allowance: All (positive) income above a basic allowance or tax credit is taxed at a flat rate. Russia and Slovakia have this second option.
- Single rate, refundable (non-wastable) allowance : All income is taxed at a flat rate, but there is a refundable tax allowance or tax credit. This credit is of equal value to all individuals, regardless of their income levels. This is often called the "basic income flat tax", where the basic income is supposed to replace all social security benefits in addition to introducing a flat tax rate on personal income.

He went on to note that in the United States, flat tax proposals often include important provisions regarding the taxation of savings income:

> A fourth type of flat tax, which is the one most commonly discussed in the United States, is the flat rate consumption tax (this is the so-called Hall-Rabushka's flat tax proposal[4]). In this system, all income that is not saved is taxed at a single rate. Income from savings is only taxed at the corporate level at the same flat rate. Perhaps the most controversial element of the more pure variants, one surely to attract stiff opposition if seriously considered, is non-deductibility of interest.
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> A common feature with all flat tax proposals is that the introduction of a single rate is combined with an elimination of all or most tax reliefs, and it is mainly this which makes flat tax proposals simpler than existing progressive systems. In addition, it will simplify the system if the same flat rate is introduced for both personal and corporate income as the incentives to income shifting between the personal and the corporate sector are reduced or even removed.

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3 "Leader: the flat-tax revolution", *Economist*, 16 April 2005

4 [Robert Hall and Alvin Rabushka, two academics at Stanford University, made the case for flat taxes in a book entitled - suitably enough - *The Flat Tax*, published in 1985; a second edition appeared in 1995, when it attracted a considerable amount of attention.]

Those in favor of flat taxes also often argue that the reduction of tax reliefs in practice will lead to a fairer tax system and have a positive effect on redistribution, because the value of deductions increases with income in a comprehensive tax system (at least if marginal rates are progressive) and because high income persons are generally in a better position to take advantage of all allowances than low and medium income persons. In addition, it is often argued that a lowering of the tax rate will stimulate the economy and lead to increased employment, which will normally have a positive effect on income distribution.

Four concluding comments on flat taxes :

- There is nothing magical about one rate. All countries have been moving away from multiple rate schedules. But one rate is probably simpler to operate.
- Flat taxes can be progressive and do not necessarily lead to lower effective tax rates at lower-middle income revenues.
- Flat tax systems can be designed to lower or raise existing revenue yields.
- To get the full benefits of a flat tax you need to get rid of the loopholes, allowances, etc.[5]

Most attention has been paid to the introduction of flat taxes in Slovakia in 2003, and in Russia in 2001. In the first case, it appears to have been Slovakia's access to the EU in 2004 that was a critical development – as the *Economist* noted, "thereby gaining complete and unfettered access to Europe's single market. The paper went on to observe, "as advocates of the flat tax had long predicted, Slovakia's fiscal innovation helped to spur foreign investment and economic growth, while actually leading to a slight increase in tax revenues."[6] The evidence is not clear cut. As the *Financial Times* noted, "[Slovakian] officials say the flat tax has helped attract investors [but] the real drawing power, according to tax specialists and company managers, comes from Slovakia's low wages and low corporate taxation."[7] Writing in the same newspaper Martin Wolf noted, "the early adopters [of flat taxes] are relatively poor countries with correspondingly large catch-up opportunities. Estonia is not an economic benchmark for the UK."[8]

In Russia's case it has been the sheer scope of reform that has attracted comment. Writing in the *Financial Times* in February 2005, Madsen Pirie, president of the Adam Smith Institute, observed, "some critics suggest that flat tax works only in smaller, less developed or transitional economies. It is true that its practitioners include several of the former communist states of eastern Europe. But Hong Kong is by no means a less developed economy and Russia is not a small one. Hong Kong has had flat tax since 1948; Russia since 2001."[9]

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5 Jeffrey Owens, *Introductory remarks: fundamental tax reform: the experience of OECD countries* November 2004 pp 7-8; presented at the Tax Foundation 67th National Conference, 18 November 2004. Full details of the conference are at: http://www.taxfoundation.org/news/show/1060.html

6 "Charlemagne – flat is beautiful", *Economist*, 5 March 2005

7 "Advocates of flat tax point to 'success' in eastern Europe", *Financial Times*, 29 March 2005

8 "The case for a flat tax is overblown", *Financial Times*, 9 September 2005

9 "Comment: why the case for a flat-tax system is irresistible", *Financial Times*, 17 February 2005

The Russian experience was discussed at more length in a longer paper supporting the introduction of flat taxes published by the Adam Smith Institute in 2004. Summarising the economic case the author writes, “proponents of the flat tax are convinced that the existing progressive tax system raises a barrier against working extra hours, reinvesting, or saving … They argue that if tax rates were lowered, people would have a greater incentive to work and invest, which would boost the whole economy.” On the Russian experience he notes:

> Free marketers around the world were somehow surprised when Russia switched to the flat tax system in 2001. Indeed, Russian President Vladimir Putin, the former head of the Soviet KGB, took a very radical step when he replaced the previous three-bracket system with a top rate of 30 percent with a low flat rate. The introduction of the 13 percent flat personal tax on January 1, 2001, followed by the 24 percent corporate tax on January 1, 2002, made the Russian tax system much simpler, more efficient and business-friendly than it was prior to 2001.
>
> Four years after the implementation of the flat personal income tax, total real receipts from the personal income tax have more than doubled. After adjusting for inflation, personal income tax revenue increased 25.2 percent in 2001, 24.6 percent in 2002, 15.2 percent in 2003, and is predicted to total over 16 percent in 2004. This constant expansion of the government tax revenue is the result of less tax evasion and increased incentives to work, save, and invest.[10]

However, the evidence for any causal relationship is, to put it mildly, quite weak. On the question of improving tax compliance, two academics in a paper published in March 2005 for the Brookings Institution – Clifford Gaddy and William Gale – found that “although there was a significant increase in compliance following the 2001 reform, it is more likely attributable to changes in the administration and enforcement of tax laws and to other structural changes than it is to lower rates.”[11] As the *Economist* has observed:

> On January 1st 2001, Russia flattened and broadened its personal income taxes, collapsing 12%, 20% and 30% bands into a single, uniform 13% rate. The state also withheld taxes at source, identified taxpayers by number, and audited suspected tax-dodgers. Messrs Gaddy and Gale note that no tax system could hope to bring in much revenue without these rudimentary instruments of tax enforcement.[12]

A second study published by the IMF found *no* evidence that the new Russian tax system had improved work incentives:

> It is hard to attribute the very strong performance of personal income tax (PIT) revenues after the reform to tax reform itself. This conclusion emerges from both the broad macro evidence and, even more strikingly, from the analysis of micro-level

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[10] Andrei Grecu, *Flat Tax – the British case*, Adam Smith Institute 2004 p 5, 15

[11] Clifford G. Gaddy & William G. Gale, “Demythologizing the Russian Flat Tax”, *Tax Notes Int’l*, March 14, 2005, p 983 – published at: http://www.brook.edu/dybdocroot/views/articles/20050314gaddygale.pdf

[12] “Special report: simplifying tax systems”, *Economist*, 16 April 2005 p 71. The piece provides quite a detailed survey, and is reproduced in full at the end of this note, with some suggestions for further reading.

> data … Nor is there any evidence that the rate reduction had any strong incentive effect, with labor supply changes over this period being essentially the same for both those affected and those unaffected … Our analysis suggests that the strength of PIT revenues in Russia over this period was largely driven by an increase in real wage rates unrelated to the reform. This may have been associated with the strong energy prices, wider structural reforms, or simply a return to more normal trend levels, and in any event a full understanding is likely to hinge on features of Russian labor markets.[13]

The authors had found evidence of a substantial improvement in the level of taxpayer compliance, but again, this could not simply be attributed to the new flat tax:

> The evidence also points to a marked increase in tax compliance following the reform, with the evidence pointing to an increase of around 16 percentage points in the proportion of their income declared by those affected by the reform. Though the precise estimate should be treated with great caution, there are clear signs of a significant effect.
>
> One cannot necessarily attribute this improvement in compliance to the parametric tax reform itself, however. It might reflect the efforts in improved enforcement undertaken by the Russian authorities at around the same time. There is, however, no obvious way of exploring this potential explanation with the data available to us. One could hope to identify effects from any differential changes in enforcement (audit rates and the like) across the regions (enabling a further dimension on differencing), but we have not been able to track down information of this kind. Whatever its cause, however, there is little doubt that a strong improvement in compliance did take place around the time of the flat tax reform, and that this at least mitigated the revenue loss otherwise associated with the parametric reform.[14]

Discussing the conclusions of the report, the *Economist* observes, “Russia’s experience … suggests that the principal virtue of the flat tax is its simplicity. The government’s revenues did not surge because Russians suddenly squared their shoulders and straightened their backs. Rather, Russia’s tax system became easier to administer and easier to comply with.”[15] So, if tax systems were simplified in Western economies, could one expect a significant improvement in compliance? The IMF survey suggests that there is another difficulty in using the Russian experience in this manner: the sheer size and scope of the hidden economy in Russia, and in other transition economies, compared with the developed nations. The authors quote estimates that the shadow economy accounted for over a *third* of Russia’s total economic activity in the mid to late 1990s.[16]

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13 Anna Ivanova, Michael Keen, & Alexander Klemm, *The Russian Flat Tax Reform: IMF Working Paper WP/05/16*, January 2005 pp 40-1. Published at: http://www.imf.org/external/pubs/ft/wp/2005/wp0516.pdf

14 *op.cit.* p 40

15 “Special report: simplifying tax systems”, *Economist*, 16 April 2005 p 71

16 *IMF Working Paper WP/05/16*, January 2005 p 42

One question must be whether any equivalent gain is feasible in countries where the degree of compliance would be expected to be much lower. There are no reliable overall estimates of the revenue lost by the UK Exchequer as a result of the shadow economy.[17] That said, in the 2004 'O'Donnell review' on the merger of the revenue departments it was noted that the 'tax gap' – the gap between the theoretical tax payable and the amount collected – was likely to be in the region of 8-12.8% - estimates made for Sweden and the United States, respectively.[18] As one letter to the *Economist*, critical of the paper's editorial position on this issue, argued:

> It is no accident that most of the countries pursuing a flat tax policy also have high corruption, oversized black markets and low tax revenues. In these countries the flat tax is designed to tax previously unregistered income and advocates of a flat tax differ from those in the West on a crucial point: they want the rich to pay no less than the average person, not, as you assume, no more.[19]

In July 2005 the Treasury published a series of papers it had prepared on flat taxes, following a request under the Freedom of Information Act.[20] In an analysis of the Eastern European experience, the authors commented:

> Debates over the benefits of a flat tax structure have been greatest in Slovakia's border countries, the Czech Republic, Poland and Hungary, not only because some fear that their relative competitiveness may now be at risk, but also because the benefits of the flat tax structure seem to present an attractive remedy for administrative and economic challenges which are common to transition countries. However, in all discussion on flat tax structures it must be remembered that the debate is in part so fierce because so little hard evidence exists to support the pro-flat tax claims. The lack of raw data to support and substantiate proponents' claims is evident in this paper as well.[21]

B. Debate about flat taxes in the UK

The intellectual case for flat taxes was summarised by Madsen Pirie, the president of the Adam Smith Institute, in a piece for the *Financial Times* in February 2005:

> In place of the various tax bands, exemptions and allowances that feature in a progressive tax regime, flat tax replaces them with a single rate. Typically, it excludes low earners from paying any income tax at all and sweeps away the tax allowances that made the graduated system so complex. It works on two levels. The single rate is

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17 HC Deb 26 April 2004 c 759W

18 HM Treasury, *Financing Britain's future*, Cm 6163 March 2004 para 2.48

19 "Letter: falling flat on the flat tax", 19 March 2005

20 HM Treasury, *Flat Taxes*, 29 July 2005
At: http://www.hm-treasury.gov.uk/media/CFA/92/foi_flattax010805.pdf

21 *Flat Taxes*, 29 July 2005 p 3

> set sufficiently low that compliance shoots up. It is less worthwhile to avoid tax by complicated tax shelters and less worthwhile to evade it by criminal failure to declare income. The second effect is that the low rate increases the reward of extra effort and risk-taking. Since people can now keep a higher proportion of what they earn, extra earning becomes more attractive. Both the higher compliance and the expansion of economic activity contribute to broadening the tax base. This explains one of the most paradoxical features of flat tax: the fact that it rapidly brings in more revenue at the lower rate. It does so because the lower rate is charged on more income.[22]

One criticism of this analysis, made by John Kay in an earlier piece to appear in the paper, is that it ignores the underlying cause of complexity in the income tax code:

> The main reason tax codes are so complex is that income is inherently a complex concept. The most widely cited definition of income is that of Sir John Hicks: income is what a man can spend and expect to be as well off at the end of the period as at the beginning. You do not have to be a Nobel prize-winning economist to recognise that translating that definition into a tax code or a set of generally accepted accounting principles is going to be difficult. Experience of tax legislation and the regulation of corporate accounts has confirmed this. I remember a debate on principles of income measurement. A revenue official and a tax practitioner, impatient with academic argument, asked: "Why can't we just stick with the commonsense definition of income?" The hundreds of pages of the tax code are the product of unsuccessful attempts to articulate the commonsense definition of income.
>
> Income tax works relatively well when the accrual of income corresponds to the receipt of cash, as for wages and salaries or interest and dividends. Income tax does not work well when there is no such correspondence - when there are benefits in kind, when income accrues but there is no realisation, or when it is not clear where or to whom income accrues when it arises. Most of our income tax legislation, and most of the avoidance opportunities that arise from it, result from these problems.[23]

In his article Mr Pirie responded to this point as follows:

> Of course, there are theoretical objections to flat tax and John Kay raised some of them on these pages last Wednesday. Critics say it is difficult to define what income is and that is why we need thousands of pages of tax regulations. But the overwhelming majority of people in Britain are paid wages or salary, perhaps with a few easily quantified benefits such as subsidised meals. For all but a tiny minority, their taxable income would be obvious. Indeed, the same difficulties apply to the present system. Income is no more difficult to define under flat tax than it is now. It is easier.[24]

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22 "Comment: why the case for a flat-tax system is irresistible", *Financial Times*, 17 February 2005
23 "Comment: why tax cannot be expressed on a postcard", *Financial Times*, 8 February 2005
24 "Comment: why the case for a flat-tax system is irresistible", *Financial Times*, 17 February 2005

Of course, proportionately speaking, it is only a minority of taxpayers at the upper end of the income spectrum who have the means to use professional tax planning, exploiting what loopholes exist in the law. This does not mean that the sums of money at stake are insubstantial. A second criticism that has been made is that there is no reason why withdrawing tax allowances and deductions must be associated with introducing a single flat rate of tax – as one letter, responding to Mr Pirie's piece, pointed out:

> Like many flat-tax advocates, Dr Pirie purposefully and unnecessarily links a flat rate of tax with elimination of exemptions and allowances. It is possible to eliminate the allowances while maintaining a progressive tax rate structure; in fact this was the general outline of the 1986 tax reform in the US. Many here would agree with the need to limit allowances, which tend to favour the wealthy anyway (for example, US tax subsidies for housing go disproportionately to the top 1 per cent of income earners), but there is no need also to eliminate the progressive rate structure to accomplish this goal.[25]

In his article John Kay described something of natural process in the development of tax systems over time, with alternating periods of unchecked growth and determined pruning:

> Some complexity, as the flat taxers have argued, is attributable to the accretion of allowances and ad hoc reliefs. Members of Congress secure favours for constituents; finance ministers canvass their advisers for pieces of economic or social engineering. Every few years, these measures need to be cleared away, like the barnacles that adhere to the hull of a ship. Tax reformers in the 1980s made a good job of this, but since then the concessions and the gimmicks have been making their way back.[26]

From a slightly different perspective David Martin, writing for the Centre for Policy Studies, has noted that although, in his view, "at least half of [the UK's tax law] could be hacked away given any priority for simplification on the part of the Government … there would remain however, a nexus of provisions whose retention is probably justified, notwithstanding that they stood in the way of complete simplicity":

> An example would be group relief, whereby tax losses of one company in a group can be surrendered to eliminate profits of another company in the group. Without such a provision, existing groups would be tempted for tax reasons to conduct all their businesses through one company, which may not be commercially efficient. Another example would be roll-over relief whereby capital assets used in a business can be replaced without an immediate tax liability. Without such provisions, commercial life would be considerably inhibited, even if the tax rate were significantly reduced.[27]

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[25] "Letter: Tax allowances can be eliminated while preserving a progressive rate structure", *Financial Times,* 21 February 2005

[26] "Comment: why tax cannot be expressed on a postcard", *Financial Times*, 8 February 2005

[27] David Martin, *An overview of the flat tax*, Centre for Policy Studies September 2005 p 3

Mr Martin also argued that it was naïve to suggest that lower tax rates would solve the problem of tax avoidance:

> Lower rates of tax would not, in themselves, remove the desire of taxpayers to minimise their taxes. Neither would lower tax rates achieve a new culture so antipathetic to tax avoidance that it ceased to be an issue. While simpler taxes would need simpler anti-avoidance rules, rules would still be needed to cover such tax devices as diverting profits overseas, issuing special classes of shares to employees for avoidance purposes, renting clothing and other items to employees and then selling it shortly afterwards to them for their second hand value – to name but a few possibilities.[28]

Of course, one reason for those supporting a flat tax to also support the abolition of tax reliefs are the Exchequer costs involved, which even sympathetic commentators acknowledge may be colossal. The Adam Smith Institute has published estimates showing that setting a flat tax at 22%, a tax-free allowance at £15,000 and abolishing most tax reliefs except those for charitable donations, personal pensions and owner-occupied housing, would cost in the region of £63 billion.[29] The author argues that the magnitude of this cut in tax revenues would be short-lived, thanks to the new system's impact on work incentives and tax avoidance, and that in the transition to a flat tax, the greatest savings would be enjoyed by those with incomes just below the average. A critical commentary published by the Institute of Public Policy Research noted certain problems with this assertion:

> [The author] argues that the benefits of the flat tax benefit be felt most by the poor, as the poorest third would pay no income tax. By demonstrating the distribution of tax savings as a percentage of income, rather than in absolute terms, and by combining the effects of a single tax rate with the effects of heavy tax cuts, the report gives only half the picture. It also neglects to assess the short- and long-term impacts that may arise from the proposed spending cuts, which include abolishing blind person's allowance and business tax credits for research and development ... The apparent objectives of the flat tax are thoroughly desirable, but the flat tax itself is a poor way of achieving them.[30]

Other analysis of the distributional impact of a flat tax has argued that it would be people on modest incomes who would lose most from the introduction of a flat tax.[31] A study published by the consultancy Lombard Street Research noted, "the top 10% of income earners pay 50% of all income tax revenue. A flat income tax rate, whether with existing reliefs and allowances or only the existing personal allowances, massively rewards the few high income big payers and modestly to seriously penalises the main lower income and smaller payers."[32]

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28 *An overview of the flat tax*, September 2005 p 3

29 Richard Teather, *A Flat Tax for the UK: a Practical Reality - Adam Smith Institute Briefing*, 2005 p 8

30 Dominic Maxwell & Rachel O'Brien, "Commentary" *Public Policy Research*, IPPR June–August 2005 p 69

31 for example, "A flat tax would flatten the Tories", *Financial Times*, 13 September 2005

32 Brian Reading, "Flat tax – an idea whose time has gone" in *Monthly Economic Review*, Lombard Street Research September/October 2005 pp 5-6. The report is discussed in, "Flat tax does not mean a level playing field", *Guardian*, 10 October 2005.

While acknowledging the drawbacks to flat tax schemes, in a leader the *Economist* suggested the attraction of the flat tax was that it provided an effective strategy for tax simplification:

> Once tax codes have degenerated to the extent they have in most rich countries, laden with so many breaks and exceptions that they retain nothing of their original shape, even the pretence of any interior logic can be dispensed with. No tax break is too narrow, too squalid, too funny, to be excluded on those grounds: everybody is at it, so why not join in? At the other extreme, the simpler the system, the more such manoeuvres offend, and the easier it is to retain the simplicity.
>
> In Britain, election notwithstanding, tax simplification is nowhere on the agenda: why not? George Bush has at least appointed a commission to look into tax reform. But its terms of reference are so narrow that it could not suggest a flat tax even if it wanted to. This is a great pity. A flat tax would not eliminate the need for spending control; it would not deal with the impending financial distress of Social Security and Medicare; it would not even settle the arguments about the so-called consumption tax (since in principle a flat tax could take as its base either all income, or income net of savings, in which case it would act as a consumption tax). There are things it cannot do and questions it does not answer. But the gains from a radical simplification of the tax system would be very great. The possibility should not be excluded at the outset.[33]

A wider question is whether this degree of political change is feasible. It seems politically naïve for the author of the Adam Smith pamphlet cited above to argue a UK flat tax is achievable as "all taxpayers would be better off under the reform", while he anticipates, among other changes, the abolition of all tax-privileged savings vehicles, the withdrawal of age-related allowances for those over 65 years age, and taxing all previously tax-exempt state benefits, such as child benefit.[34] Radical change in the tax system is not merely a question of the considerable sums of money at stake, but also the role the tax system plays in everyone's life – both here, and, as the *Economist* noted, glossing on Adam Smith's own reservations about the tax system, across the Atlantic:

> In part, 'trouble, vexation and oppression' are the price Americans pay for the tax exemptions, deductions and concessions they cherish so much. As well as raising revenue, America's tax code is charged with inspiring charitable giving, promoting homeownership, defending marriage and delivering pork to the favoured constituencies of ambitious congressmen. If America's tax system asks a lot of its citizens, it may be because they ask a lot of it.[35]

David Martin made a similar point in his pamphlet on flat taxes cited above:

> Tax incentives may be appropriate where it is to the public advantage for someone to do something but he needs a public grant to make it worthwhile for him to do it. An

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[33] "Leader: the flat-tax revolution", *Economist*, 16 April 2005
[34] *A Flat Tax for the UK*, 2005 p 8
[35] "The burden of complexity", *Economist*, 16 April 2005

> efficient way of providing a grant is often through the tax system. It should be noted that the ultimate purpose of such incentives is not so much to lighten the burden of higher tax rates on the individual taxpayer but for the common weal.[36]

In July 2005 the shadow Chancellor George Osborne published a piece in the *Spectator* on the advantages inherent in flat taxes, although he noted that it was misleading to make simple comparisons between Eastern European countries and the UK:

> What the Central and Eastern European countries all have in common is that they have introduced the flat tax into economies that did not have a long-established income tax system. They started with a fairly clean slate, while in Britain we have a direct tax system that has developed since Pitt the Younger has to finance war with France. There are established exemptions, such as tax-free savings for pensions or tax-free donations to charity … We must be clear … that introducing a pure flat tax into the UK would mean having to overcome some major obstacles.[37]

In a speech in September Mr Osborne argued that the Conservatives should make the case for "lower, simpler flatter taxes"[38] and to this end announced that a 'Commission on Tax Reform' would "look at the prospect of simpler and flatter taxes that fall short of a pure flat tax."[39] This body, chaired by Lord Forsyth, was set up the following month and plans to issue its report "in the third quarter of 2006."[40]

For its part, the Government's position on the issue was summarised in a written answer:

> **Lord Steinberg asked Her Majesty's Government:** Whether they have considered a flat tax regime; and what is their current view on this issue. [HL1545]
>
> **Lord McKenzie of Luton:** Fairness is a key principle of the tax system and one to which this Government are firmly committed. The Government do not believe that introducing a flat tax in the UK would enhance the fairness of the tax system or the Government's economic and social objectives. The Government keep all taxes under review and any changes to taxation are considered as part of the normal Budget process.[41]

36 David Martin, *An overview of the flat tax*, Centre for Policy Studies September 2005 p 4
37 "The flat tax revolution", *Spectator*, 9 July 2005
38 "Osborne to make case for flat rate tax", *Financial Times*, 8 September 2005
39 "Letter from George Osborne "Proposals for a flat rate tax", *Financial Times*, 12 September 2005
40 The Commission's site is at: http://www.taxreformcommission.com/
41 HL Deb 19 October 2005 c 128WA

C. Appendix: selected further reading

There has been a considerable amount of commentary in the press over recent months on the arguments for and against flat taxes. The Adam Smith Institute is one of the strongest advocates of this type of reform; see for example,

Andrei Grecu, *Flat Tax – the British case*, Adam Smith Institute 2004
At: http://www.adamsmith.org/images/uploads/publications/flattax.pdf
Richard Teather, *A Flat Tax for the UK: a Practical Reality*, Adam Smith Institute 2005
At: http://www.adamsmith.org/pdf/flattaxuk.pdf

A more cautious overview of the arguments, noting a number of practical difficulties, and suggesting a more gradual approach to tax simplification is given in:
David Martin, *An overview of the flat tax*, Centre for Policy Studies September 2005
At: http://www.cps.org.uk/pdf/pub/415.pdf

From a slightly different perspective, the think-tank Reform has made the case that 'flat tax countries grow faster' – so that cutting tax rates would boost government revenues; work on this theme is collated on their site at:
http://www.reform.co.uk/website/economy/taxation/impactoneconomicgrowthandrevenues.aspx
Sir Christopher Gent, chairman of Reform's Advisory Board, wrote an opinion piece for the *Financial Times* on this theme in May 2005 ("Tax reform is crucial for Britain", 4 May 2005). See also, "The Tories must wish they'd listened as Gent makes the case for a flat-rate tax system", *Independent*, 5 May 2005.

Arguments against the flat tax have been discussed in:
"Why flat means unfair", *Guardian*, 6 September 2005
"The case for a flat tax is overblown", *Financial Times*, 9 September 2005
"One tax that the rich will love", *Observer*, 11 September 2005
"Flat tax does not mean a level playing field", *Guardian*, 10 October 2005

A survey of these arguments is given in "A fiscal wind", *Taxation*, 13 October 2005, and in "The flat tax pancake … and the broken eggs", *Tax Journal*, 26 September 2005. They were also set out by those contributing to a short debate in the Lords on income tax in June 2005 (HL Deb 7 June 2005 cc 855-868).

Further to this, a survey of those Eastern European countries which have introduced flat taxes in recent years appeared in the *Economist* in April, and is reproduced in full below:

“Special report: simplifying tax systems - the case for flat taxes”, *Economist*, 16 April 2005

Pioneered in eastern Europe, flat tax systems seem to work because they are simple

AN ARTFUL taxman, according to Jean-Baptiste Colbert, treasurer to Louis XIV, so plucks the goose as to obtain the most feathers for the least hissing. Such arts are lost in America. As the April 15th deadline for filing tax returns falls due, the hissing is as audible as ever. But Americans are not alone. New Zealand's tax code instils "anger, frustration, confusion and alienation" in the islands' businessmen, according to a 2001 report to ministers. Adam Smith spoke for many when he bemoaned the "unnecessary trouble, vexation, and oppression" the people suffer at the hands of the tax-gatherers.

The White House claims to be listening. Shortly after his election victory, President George Bush set up a panel to advise him on how to reform the tax system. A report is expected this summer. Judging by the remit he has given them, Mr Bush wants to iron out some of the kinks in the tax code that distort saving and deter work, while retaining tax breaks for charity and homeownership. But he also wants to simplify the tax code for simplicity's sake.

The Americans are talking about it. Meanwhile in Europe, east of Vienna and as far afield as Russia and Georgia, they are actually doing it. In 1994, Estonia became the first country in Europe to introduce a so-called "flat tax", replacing three tax rates on personal income, and another on corporate profits, with one uniform rate of 26%. Simplicity itself. At the stroke of a pen, this tiny Baltic nation transformed itself from backwater to bellwether, emulated by its neighbours and envied by conservatives in America who long to flatten their own country's taxes. Latvia and Lithuania, Estonia's Baltic neighbours, promptly followed its example. In 2001, Russia too moved to a flat tax on personal income. Three years later, Slovakia imposed a uniform 19% rate on personal and corporate income, and set the same rate for its value-added tax (VAT) too, for the sake of symmetry rather than economic logic, it seems. In Poland, Civic Platform, a centre-right opposition party, wants to mirror Slovakia, only at the lower rate of 15%. In all, eight countries have now followed Estonia …

Might America do the same? The tax system there has been debated for years. William Simon, America's treasury secretary under President Richard Nixon, wanted a system that looked "like someone designed it on purpose". But the bewildering bulk and complexity of a modern tax code is not only the result of poor or malicious design.

Fairness is the chief reason why most countries have imposed multiple rates of tax. In Canada, Australia and the European Union, for example, staple foods, but not restaurant meals, are exempted from value-added tax. This is deemed fair because the poor spend a greater share of their income on unprepared food. It can lead to nonsense, however. Jeffrey Owens and Stuart Hamilton of the OECD point out that hot roast chicken is taxed, but cold roast chicken is not. "Does anyone expect tax administrators and business owners to have thermometers on hand when they do their tax calculations?" they ask, only half in jest. In Luxembourg tax collectors work with no fewer than 17 different tax brackets, to ensure rich Luxemburghers pay a greater proportion of their income than their slightly less rich countrymen. The international trend, however, is away from such pointillism towards broader brushwork. Between 2000 and 2003, the OECD reports, seven of its members (including Luxembourg) cut the number of brackets, although Canada, Portugal and America all added one.

Fewer brackets are simpler to administer, but one bracket is simplest of all. Under a pure flat tax, the taxman takes the same cut from the last dollar you earn that he took from the first. The appeal to high earners is obvious. But the administrative elegance of such a system is not so immediately apparent. Because every dollar is taxed at the same rate, it does not matter to the tax collector how many dollars are going to whom. Thus, in principle, the taxman could simply withhold 20% of a company's payroll, without needing to know who was paid what. Add a second rate of tax, however, or a personal exemption, and the tax collector must find out how much money is going into each pay packet before he can be sure of collecting the right amount from the right person. In America, for example, the tax collector needs to tax the wage packets of 130m or more employees, rather than simply taxing the payrolls of 8m or so enterprises.

How much fairness is gained for all this extra complexity? Surprisingly little, suggest Messrs Owens and Hamilton. In New Zealand, for example, only the richest tenth of households pay much more under the country's progressive income tax than they would under a 25% flat tax … Most of the redistribution in New Zealand is carried out on the other side of the government's ledger, by spending more money on poor people.

To the layman, a flat tax simply means a single rate of income tax. But the connoisseur of the flat tax can distinguish several different varieties. In America the flat tax is associated with a proposal advanced by Robert Hall and Alvin Rabushka, two economists at the Hoover Institution. Their tax, which falls on businesses and households, and allows a personal exemption, is designed not to tax saving. It thus resembles a consumption tax, such as VAT, more than a traditional income tax, which is typically also levied on returns to saving, such as interest and dividends. Slovakia, which taxes profits firms make, but not the dividends they distribute, perhaps comes closest to this model.

Nor are flat taxes synonymous with low taxes. Certainly, most countries have cut their tax rates as they have flattened them. In 1994, Ukraine's top rate reached the stratospheric level of 90%, before descending, in stages, to its current single rate of 13%. But Lithuania's 33% flat rate is too high for some American conservatives. Nevertheless, Lithuania's example might make flat taxes more palatable to the social democrats of western Europe. Miguel Sebastián, an economic advisor to Spain's socialist government, has advocated (largely in vain to date) a flat tax of 30% on Spanish incomes. Last year, a panel of academics set up by Germany's finance ministry also proposed a 30% flat tax on all personal and corporate income.

Flat taxes differ in scope as well as height. Since 2001, Russia has imposed a single 13% tax rate on all personal income. But it has a different rate for corporate profits: 35% at the time of its 2001 reform. Slovakia's flat tax, by contrast, covers both personal income and corporate income, as well as VAT. Taxing pay packets and profits at the same rate discourages an obvious form of "tax arbitrage". For example, it was reportedly quite common for Slovak salarymen to declare themselves self-employed, while continuing to work for the same company much as before. Their wages would then be taxed as profits. Not only that, their lunch could be counted as a business expense.

Unfortunately, Slovakia's fiscal purism is somewhat adulterated by a heavy payroll tax. The social-security contributions of employees and employers combined amounted to almost half of labour income in 2004. Since this burden falls on earnings from work, not from capital, it restores the incentive for Slovaks to convert one into the other, by declaring themselves self-employed subcontractors. It may also drive some economic activity into the shadows, where the social-security agency cannot find it.

At the time of its reform, Estonia also taxed labour and capital at the same rate. After 2000, however, it chose not to tax profits at all until they are distributed to shareholders as dividends. This gives companies an incentive to retain their earnings and reinvest them. Indeed, very little of the burden of taxation in Estonia falls on corporations directly: corporate taxes accounted for only 3.6% of total tax revenues in 2003.

Estonia's economy has grown impressively since its 1994 reform. Growth reached double digits in 1997, and has since settled at around 6% annually, after a slump at the turn of the century. Repealing its high tax rate on the rich did not erode the country's tax base as some might have feared. In 1993, general government revenues were 39.4% of GDP; in 2002, they were 39.6%. Estonia now plans to cut its flat tax from 26% to 20% by 2007.

But how much do Estonia's robust revenues owe to its flat income tax? Perhaps less than is frequently advertised. In 1993, the year before its reform, Estonia's multiple personal income taxes raised revenues amounting to 8.2% of GDP. In 2002, its flat income tax raised revenues worth just 7.2%. Indeed, the flat income tax that generated so much excitement abroad seems to be carrying less weight than Estonia's old-fashioned VAT, which raised 9.4% of GDP in revenues in 2002.

VAT is, of course, the flattest tax of all. It levies a uniform rate on the goods you buy, taking a constant cut of your money when it is spent as opposed to when it is earned. Estonia's VAT is also quite broad, leaving relatively few things out (hydropower and windpower were two curious exceptions). The same point could be made about Slovakia. At 19%, it has a relatively low rate of income and corporate taxes, but one of the highest rates of VAT in Europe. It may be this high rate of VAT, not the flattening of its other taxes, that sustains the government's revenues in the future.

The most remarkable turnaround in government revenues was recorded in Russia. Prior to its 2001 tax overhaul, the federal government's tax-raising powers were rapidly deserting it. Clifford Gaddy and William Gale of the Brookings Institution report that tax arrears amounted to 34% of collections in 1997. By 1998, federal revenues had fallen to just 12.4% of GDP, leaving the government unable to pay its creditors. Investigators appointed by the president revealed that Russia's biggest enterprises ignored 29% of their taxes and paid another 63% in kind, with goods and services the government might or might not want. In lieu of $80,000 in taxes, one company reportedly offered the government ten tonnes of toxic chemicals.

On January 1st 2001, Russia flattened and broadened its personal income taxes, collapsing 12%, 20% and 30% bands into a single, uniform 13% rate. The state also withheld taxes at source, identified taxpayers by number, and audited suspected tax-dodgers. Messrs Gaddy and Gale note that no tax system could hope to bring in much revenue without these rudimentary instruments of tax enforcement.

How did revenues respond? A year after the reform, the personal income tax was raising almost 26% more revenue in real terms. Some of this was due to the rebound in the economy: real wages grew by 12% that year, and the take from all taxes, flat or otherwise, consequently improved. But the surge of rubles encouraged by the flat tax was more sustained. A careful study by two IMF economists, Anna Ivanova and Michael Keen, together with Alexander Klemm, of the Institute of Fiscal Studies in London, tries to unearth the causes of this pleasant fiscal surprise. They find little evidence that Russians, freed from the yoke of progressive taxation, suddenly started working much harder. This is perhaps not surprising, as Russia's reform actually raised personal income taxes for the many households that previously fell into the 12% bracket. They did discover a conspicuous increase in compliance with the tax authorities, however. In the year before the flat tax, Russians in the two higher tax brackets reported only 52% of their income to the taxman. In 2001, after falling into the new, all-encompassing 13% bracket, these same households reported 68%.

Many advocates of the flat tax, particularly in America, argue that it sharpens the incentive to work. A progressive income tax, they claim, deters extra effort from society's best-paid (and therefore most productive) members. Russia's experience, however, suggests that the principal virtue of the flat tax is its simplicity. The government's revenues did not surge because Russians suddenly squared their shoulders and straightened their backs. Rather, Russia's tax system became easier to administer and easier to comply with.

America is not Russia. It has a functioning tax system, albeit a clumsy one, so has something to lose from uprooting its tax system and starting again. But the potential gains are not negligible. In a typical year, the IRS estimates that for every dollar it collects, another 19 or 20 cents is owed, but not paid. This shortfall amounted to between $312 billion and $353 billion in 2001. Small businesses fail to report about 30% of their earnings. Babysitters and gardeners fail to report 80%, says the IRS.

In part, the tax system is burdensome because people dodge it. Every loophole that is exploited must be plugged. Every blurry line that is crossed must be sharpened. But Messrs Owens and Hamilton worry that the tax-codifiers and the tax-dodgers are locked in a mutually destructive "arms race". The code is made more complex, because of tax wheezes. More people then seek to avoid taxes. The best way to fight tax avoidance, then, is with simplicity. As every American knows, their country was founded in the wake of a tax revolt. What most forget is that the so-called "Boston tea party", a raid on the cargo of British ships in Boston harbour, was not provoked by a tax hike. The British had in fact scrapped duties on tea, cutting out commercial middlemen. It is not going too far, then, to suggest that the American Revolution was provoked by a simplifying tax reform. Mr Bush must hope his own reforms, should they ever see the light of day, will encounter less stiff resistance.