

# Flat Tax – A Simpler Alternative?<sup>1</sup>

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## Topics

- What is a Flat Tax?
- Why Flat Tax?
- Tax Rates
- Hall-Rabushka Flat Tax
- Country examples
- Recent reports



## What is a Flat Tax?

### IBFD's International Tax Glossary

*A tax system which, in its most extreme form, would disallow exclusions, deductions and credits and impose a single "flat" rate of tax on gross income.*

## Why Flat Tax?

*The Case for Flat Taxes, The Economist (14 April 2005).*

*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. .... 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 tax-gatherers.*

## Why Flat Tax?

- Decreasing the marginal tax rate will reduce distortions, improve revenue collection and economic performance.
- Promotes greater compliance due to its transparency and simplicity resulting in revenue benefits.

5

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## Why Flat Tax?

- Compliance costs can be reduced, e.g. a reduction in keeping track of deductions and types of income.

6

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## Tax Rates

### *Average vs. Marginal tax rates*

- The average tax rate is the total amount of taxes paid in relation to the total income (e.g. if a person pays \$20 in taxes for \$100 of income, the average tax rate is 20%).

## Tax Rates

### *Average vs. Marginal tax rates*

- The marginal tax rates are relevant on an incremental basis, i.e. the rate that applies on every further \$ of income (e.g. assume the person who is paying \$20 in taxes for \$100 of income receives a \$50 raise. If \$15 of the \$50 is paid in taxes, the marginal tax rate is 30%).

## Tax Rates

### *Impact of high marginal rates*

- Lowers the return on investments and incentives for entrepreneurs.
- Tax rates have an economic impact.

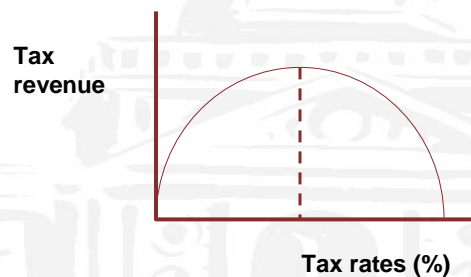
9

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## Tax Rates

- “Laffer Curve”



10

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## Tax Rates

- The “Laffer Curve” shows the trade-off between the tax rate and tax revenue
- Revenue increases at lower levels of taxation.
- But as the tax rate increases, the revenue increases are at a decreasing level. Maximum revenue is collected at the optimum point and after which, revenue will decrease.

## Tax Rates

- Supporters of the flat tax argue that progressive tax systems act against extra working hours, reinvesting and savings.
- Taxes that are higher than the optimal rate discourage people from working or investing.

## Tax Rates

### *Progressivity*

- The flat tax can achieve progressivity (i.e. those earning more pay more taxes) without the negative impact of high marginal rates.
- Taxpayers will contribute a larger amount of tax as they earn more but will not face higher marginal tax rates.
- The progressivity is achieved via a basic exemption.

## Hall-Rabushka Flat Tax

- Hall-Rabushka's principles are based on simplicity, efficiency and fairness.
- All types of income should be taxed only once.
- Income should be taxed uniformly, i.e. there should be no differences in the tax rates for different types of income.

## Hall-Rabushka Flat Tax

### *Individual taxation*

- Wages, salaries, pensions are considered to be personal income and subject to tax.
- However, items such as dividends, capital gains, interest, etc. are not as they would have already been taxed at the business stage.

## Hall-Rabushka Flat Tax

### *Individual taxation*

- All credits, deductions, exemptions, etc. should be removed.
- Individuals/families would only have to add all taxable income minus the personal exemptions and apply the flat tax rate.

## Hall-Rabushka Flat Tax

### *Business taxation*

- This would seek to tax all income that is not subject to the individual taxation.
- There will be no deductions for interest, dividends, etc.

## Hall-Rabushka Flat Tax

### *Business taxation*

- Taxable income will be total revenue less wages, salaries, etc. paid to employees.
- Also, purchases of inputs from other businesses and cost of investment will be deductible.

## Country Examples

Estonia; Slovak Republic; Russia;  
Georgia; Hong Kong, China



## Country examples

- In Europe, to date, there are 9 countries that have a 'flat tax' system, i.e. Estonia, Latvia, Lithuania, Russia, Ukraine, Georgia, Slovak Republic, Serbia and Romania.
- Other countries in Europe are also looking into the possibility of adopting flat tax, e.g. Greece and Poland.



## Country examples - Estonia

- Gained independence in 1991.
- Recognising that its existing pre-independence tax infrastructure was not adequate, a corporate income tax (CIT; 35%), personal income tax (PIT; 16%-33%) and value-added tax (VAT; 18%) system was implemented by 1994.

21

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## Country examples – Estonia

- In 1994, a 'flat tax' reform was initiated.
- Both CIT and PIT were subject to a 26% flat rate.
- Corporate and individual systems were integrated.
- The tax base was broad and investment incentives, deductions, etc. were removed.
- VAT rate remained at 18%.

22

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## Country examples – Estonia

- Another major change was seen in 2000 when corporate tax was replaced with a distribution tax (i.e. tax on distributed profits but not retained earnings).
- Limited deductions were also introduced for individuals.

## Country examples – Slovak Republic

- Formed from the Czechoslovakia split in 1993.
- The tax system was relatively onerous and the tax rates were reduced. CIT rates from 40% to 25%, and PIT rates from to 10%-38%.
- VAT rates though were increased.

## Country examples – Slovak Republic

- The 'flat tax' was implemented in 2004.
- CIT, PIT and VAT rates were set at 19%.
- Integrated tax system implemented.
- The tax base was broad and incentives, deductions, credits, etc. were kept to a minimum.

## Country examples - Russia

- Russia had a tax regime that consisted of a CIT (35%), PIT (12%-30%) and various other taxes and levies.
- There were no proper regulations on deduction of business expenses, etc. while the PIT regime had various exemptions and numerous deductions.

## Country examples - Russia

- In 2001, the PIT system was reformed. A 13% rate was introduced for most forms of income and the base broadened.
- In 2002, the CIT system was reform and the rate reduced to 24% and the base broadened.
- The VAT rate was reduced to 18% in 2004.

## Country examples – Georgia

- A new tax code was introduced in 2005.
- The new tax code rationalised the number of taxes and imposed a 12% flat tax for PIT.
- No basic allowances provided.

## Country example – Hong Kong

- After 150 years of British administration, Hong Kong reverted to Chinese rule in 1997.
- Hong Kong, China is one of the top 10 trading economies and has been ranked the freest economy (*Index of Economic Freedom*).
- Hong Kong, China has had a version of the flat tax since 1947, i.e. when the original tax system was introduced.

## Country example – Hong Kong, China

- Hong Kong, China does not have a capital gains tax, wealth tax, gift tax, value added tax, etc.
- Currently, Hong Kong, China imposes a profits tax of 17.5% for corporations and 16% for individuals; a property tax of 16%; and an individual tax that ranges from 2%-19% (but subject to a maximum cap of 16%).

## Country example – Hong Kong

- If tax is levied by personal assessment (i.e. between 2%-19%), the total amount of tax charged may not exceed 16% (i.e. the flat standard rate) of the total income after the deduction of business losses and approved expenses but before deduction of personal allowances.

## Recent Reports

Fundamental Reform of Personal  
Income Tax, OECD Tax Policy  
Studies No. 13

## Recent report - OECD

- The OECD, in 2006, published a report analysing fundamental reforms of PIT in OECD countries.
- The report recognises that increasingly tax reforms are looking at fairness and simplicity.
- The report also looks at the flat tax reforms.

## Recent report - OECD

- In Russia, it finds that administrative reforms (i.e. stronger enforcement and reform of the tax administration) has had a more fundamental impact than the low flat rates.
- In Slovakia, the effects of the flat tax on labour income is not that important as there are high social security contributions that can be deducted from the tax base.

## Recent report - OECD

### *Simplification and Compliance*

- Simple tax systems such as the flat tax may not be suitable for complex economic environments. Main problem would lie with the tax base and if this is defined properly, it should not matter if a flat tax or progressive rate system is used.

## Recent report - OECD

### *Simplification and compliance*

- Flat taxes for all types of income may reduce income shifting and reduce compliance/administration costs. However, this would not be the main reason because income shifting could also happen due to a difference in the tax base (and possible social security contributions).

## Recent report - OECD

### *Tax compliance*

- Low rates are more likely to see higher levels of compliance but moving towards a flat tax system could see rates increase for the low/middle-income persons and decrease for the high-income. This could impact compliance from the low/middle-income group.

Discussion / Questions