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THE FLAT TAX – THEORY AND PRACTICE

The key macroeconomic characteristics of the Flat Tax according to the Hall - Rabushka theory are outlined, with emphasis on the similarities and differences with the "Supply – Side Economics". The main objective is to illustrate the application of this type of taxes in the Eastern European practices, the deviations from the original proposal and the differences among them. The Bulgarian flat tax variation (2008-2009) is analyzed accordingly. Some general conclusions and proposals are made, based on this concept.

JEL: E62, H21, H23, H24

The Flat Tax proposal was first published by Robert Hall and Alvin Rabushka[1] 27 years ago on the editorial page of the Wall Street Journal on December 10, 1981 – in the article "Proposal for simplification of our tax system", and subsequently elaborated in a book.[2] In Bulgaria such type of tax was introduced one year ago. However there are not enough publications in our country, to provide a comparative study from macroeconomic point of view of the issues - essence, types, advantages and disadvantages of the Flat Tax.

Essence and key parameters of the Hall and Rabushka's Flat Tax Concept

The contemporary tax systems in the medium and advanced economies are considered economically efficient when collecting the revenues, required for public services with minimum distortions caused by them to the economic policymakers. The components therein are – optimum and diversified tax structure, in conformity with the requirements for tax equity, simplicity and transparency of the tax laws and regulations.

Especially for income taxes – the capital gains relief is considered the main problem at the turn of the millennium, by shifting the tax burden to consumption. Due to the expansion of the globalization the mobility of capital is higher than the labor mobility. Consequently two main designs, each of them with its own alternatives have received a great deal of attention in the recent years in theory and partially in practice. *The first* explicitly taxes capital income at a lower single rate and labor income at a higher progressive rate~~,~~ i.e. different taxation of both types of income. *The second* attempts to remove the tax burden on capital income completely, thus resulting in a personal income tax (PIT) that effectively targets consumption as its tax base. The Flat Tax Concept reflects this very attitude.

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[1] The term "плосък" is not the most precise translation of "flat" from the point of view of contents. More correct are "еднообразен=uniform" or "еднакъв=same" tax, but it has become popular and therefore is used here as well.

[2] *Hall, R. E. and A. Rabushka.* The Flat Tax – Hoover Institution, 1985 and 1995, http://www.hoover.org/publications/books/.

From national income accounts, gross national income (*Y*) can be expressed in two different ways:

●on the expenditure side: (1) $Y=C+I$,

where: *C* = consumption, *I* = investments;

●on the income side: (2) $Y=W+R+P+D$,

where: *W* = wages, *R* = interest, *P* = profits and *D* = depreciation.

Furthermore, investment must be equal to savings (S) by way of accounting identity $I=S$ (*S* = savings)

(3) $C=Y-S=W+R+P+D-I$.

The Tax base of a conventional personal income tax (PIT) is $W+R$, as well as *P* distributed as dividends if subject to personal income tax PIT, while that of a conventional corporate income tax (CIT) is *P*. In calculating *P* conventional accounting rules treat *W*, *R* and *D* as deductible expenses, but do not allow *I* or expenditure on capital equipment, to be deducted at the time it is incurred.

Under the Flat Tax proposal, the base of the corporate income tax (CIT) would be shifted from *P to F*, where

(4) $F=P+R+D-I$.

In other words, in calculating the taxable profits of a corporation *P* under the Flat Tax, interest and depreciation are no longer considered to be deductible expenses, but a deduction of capital expenditure is now allowed. For this reason the corporate income tax CIT becomes a cash flow tax *(F)*. It is prohibited to deduct interest expenses in order to avoid subsidizing capital expenditure financed through loans.

Thus the consumption

(5) $C=W+F=W+P+R+D-I$.

The Flat Tax encompasses the wage tax on individuals and a cash-flow tax on corporations at the same rate, resulting in an economy-wide single-rate tax (on consumption.[3] In principle this tax should be applied for the entire consumption on the domestic economy scale. In practice however, aiming to increase its political acceptability, a certain exemption threshold for wage income is instituted, and very often additional (targeted) thresholds as well. In addition, when converting the "traditional" personal income tax, which is progressive, into a part of Flat Tax this exemption threshold is nominally increased aiming to offset partially the lack of more actual tax rates at least in the lower part of the tax scale.

The "original concept" of Hall and Rabushka provides for annual personal allowance of \$16 500 for a married couple filing jointly, \$9500 for a single taxpayer and \$14 000 for a single taxpayer head of a family, and \$4500 per child. According to this scheme a married couple with two children is entitled to a total amount of

[3] The presentation on the aggregates of the Flat Tax is based mainly on *Zee, H.* Personal Income Tax Reform: Concepts, Issues and Comparative Country Developments. IMF WP/05/87, p. 36-38 and *Dalsgaard, Th.* US Tax Reform: An Overview of Current Debate and Policy Options. IMF WP/05/138, p. 17-18.

family allowance of $25 500 per year.[4] The tax reform is suggested to be income-neutral, i.e. the total Flat Tax revenue to be as much as the federal personal and corporate income taxes. According to data provided by the US Internal Revenue Service (IRS) for 1993 the total actual Flat Tax revenue amounts to $627 bln. (about 9.84% of GDP). From the gross taxable amount of the wages, salaries and pensions - $3100 bln., the family allowances amount to 55% (about $1705 bln.), and the wage tax base – 45% (about $1395 bln.). With the added business tax base of $1903 bln., a broad tax base of $3298 bln. is obtained, or about 51.74% of GDP. Thus out of the total amount of the tax: $265 bln. are from wage tax revenue, and $362 bln. – business tax revenue. Hence, if under the actual data, the fraction of the corporate tax is 18.8% of the total amount, when converted into a Flat Tax it would be 57.7%. It is due both to broadening of the tax base (for instance with interest rates), and to reporting income, currently taxed as personal, such as business tax revenue.[5]

In order to meet the requirement for income neutrality, the flat tax for the annual earnings below $ 30-35 thousand is substantially less than the current tax (1991, at 1.1 child average). From this amount – up to about $90-100 thousand, it will be higher, and upwards – it will be lower again. In addition to the accounting of investment expenses on annual basis, the average tax rate on business income will be 15% tax (due to deducting investments), and the average rate on wages (due to allowances) – 10.4%.[6]

Consequently, the key and most radical difference to the classical income taxes (personal and corporate) is rather in the segment of corporate taxation, including the elimination of double taxation of income from dividends – both as corporate income, and as personal income.

Flat Tax and "supply-side economics"

The concept on the "supply-side economics" is the most detailed theory of vital importance in practice, criticizing the Keynesian and Neo-Keynesian theories on economy and the government's interference therein. The other conservative theories of the 1970ies – the Monetarism, the "New Classics" and the Rational Expectation Concept" are not less significant. All of them, especially as far as tax and budget policies are concerned, have a common basis in the Classical Bourgeois Political Economy and its numerous branches throughout the XIXth century.

Similarities between the theoretical concept on the Flat Tax and the "supply-side economics".

1. Both of them are considered purely US phenomena, that have emerged and developed almost simultaneously: "supply-side economics" (R. Mandel and A.

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[4] *Hall, R. and A. Rabushka*. Op. cit., p. 88-89.

[5] Ibid., p. 84-85.

[6] Ibid., p. 137-139.

Laffer) – in the 1970[ies] – until 1977/1978, and the Flat Tax concept – between 1981 and 1985.

2. Both of them are against the state interference in economy, considering it rather harmful, due to the resulting distortions of the optimum proportions, dictated by the market. Such interference discourages the employment and entrepreneurial activities, pushes up the interest rates, encourages tax evasion, tax shelters and the illegal economy, and irrational investments as well as employment in natural economy (because the illegal economy and the natural economy are considered less productive). This is summed up in the weakness of economy (with monetary expression – the budget deficit) and especially in the slow economic growth rate.

3. Common negative attitude, especially towards progressive tax rates, as an instrument for "aggressive" redistribution, in particular via personal income taxes. They argue, that the progression limits individual liberty in a free society, killing the motivations and seeking a self-support.

4. Positive attitude towards broadening of the tax bases by means of limiting the various forms of tax relief and exemptions. According to A. Laffer "tax revenues are a product both of tax rates, and tax base. Increasing tax rates is assumed to decrease tax base in the same degree."[7] The horizontal equity (the equal tax treatment of equals) is generally seen as a rule to ensure fairness of a tax system [8] aimed at loyal competition. In this respect the "supply-side economics" has indisputable contributions, as the numerous forms of tax relief are due to lobby pressure. They erode the tax base, and hence – the revenues, despite of the high marginal tax rates. The reaction in the USA was the alternative minimum tax (28%), making the "tax compliance" more complicated and more expensive.

5. Pursuit of a more complete cohesion between the personal income tax rate and the corporate income tax rate (aiming to restrict the so-called tax arbitration). In the past such taxes have not always been separate. In the UK the separate corporate taxation was initiated in 1947.[9] In USA PIT and CIT have been introduced at the same time in 1913, however many economists still argue the necessity of a separate corporate tax.[10]

6. The appeal for "flattening" the progressive rate schedules (mainly for personal income taxes) reducing the number and extending the scope of the tax brackets by minimizing the difference between minimum and maximum tax rates. As the distortions are proportional to progressivity, the "supply-siders" plead for reducing the degree of progressivity. The theoretical arguments are derived from the conservative scholars of the XIX century: there is no precise criterion for progression – it is arbitrary and might result in confiscation. A requirement for the

[7] *Laffer, A. and M. Miles*. International Economics in a Integrated World. Glenview, 1982, p. 157-158.

[8] *Zee, H*. Op. cit. p. 4.

[9] *Dilnot, A. W. and J. A. Kay*. Tax Reform in the United Kingdom: The Recent Experience. – In: World Tax Reform: Case Studies of Developed and Developing Countries. San Francisco, 1990, p. 153.

[10] *Дейкин, А. И*. Механизм федерального бюджета США. Москва: "Наука", 1989, p. 57 and 72-73.

vertical equity is to function as distributive justice. How unequal should unequal incomes be treated is clearly a question of value judgment (social and moral ethical values).[11] However in practice minimum two brackets were reached plus maintaining the personal and family allowance (USA, UK).

Cutting the tax brackets by means of consolidation is actually a discrete reduction of progressivity and therefore improves the incentives to work. There is however a bracket creep, due to the inflation, decreasing the marginal tax rates much below the average (i.e. the actual tax burden). Consequently, in 18 OECD countries (incl. 12 European countries) for the period 1986-2002 the number of the tax brackets with positive tax rates has stepped down from 8 to 4, the maximum tax rate – from 54.9 to 37.6%, minimum – from 19.1 to 13.7%. At the same time the average annual basic allowance (texemption threshold) for the same period stepped up from 22.6 to 36.0% of a country's per capita income, being a partial indicator for increased progressivness. The average tax burden however was decreased much less than the maximum rates, and therefore the average rate of PIT revenues dropped down from 12.2% (1986-1990) to 10.7% of GDP (2001-2002).[12]

A similar "flattening" process as a reflection of the concept on "supply-side economics" has been observed in Bulgaria during the transition period (1991-2007). Primarily (IV/1991-II/1992) the number of the tax brackets was 7, maximum rate – 40%, minimum – 20%, the maximum rate was reached at an amount 44.4 times of the annual basic tax-free allowance (exemption threshold). For the period III/1993-III/1994 the brackets were 9, minimum rate – 20, maximum – 52%, but the highest bracket was reached at an amount, equal to 180 annual tax-free allowances. From II-V/1997 the tax brackets were 7 again, minimum and maximum rates – 20 and 40%, and the level of the maximum rate – 26.6 times of the annual basic allowance. The above parameters are similar to the ones from the initial period. Since then a continuous 10-years' "flattening" followed, and in 2007 the minimum tax rate was 20%, maximum – 24%, reached at an amount just 3 times the annual minimum tax-free allowance.[13]

7. The assertion (in principle correct), that due to the complications the progression and the tax allowances make "tax compliance" and tax collection more difficult to implement and more expensive. In this sense "fairness is not cost-free".[14]

Differences between the "supply-side economics" and the original proposal for Flat Tax.

1. If the "supply-siders" plead cohesion and alignment of both income taxes, Hall and Rabushka logically finalize everything – unifying all taxes in one tax on overall consumption in economy at a single flat rate.

2. In this regard a new tax bases is formed, quite different from the traditional tax base in the part for corporate incomes - interest expenditures and the

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[11] *Zee, H.* Op. cit., p. 4.

[12] Ibid., p. 48.

[13] Calculations made by the author, based on regulatory amendments.

[14] *Hall, R. and A. Rabushka*. Op. cit., p. 43.

depreciation expenditures are not considered deductible any more, but the investment expenditures (for capital equipment) are deducted, being written off for one year.

3. According to the authors, by combining the both income taxes the "double" taxation of capital gains (dividends) is eliminated completely (according to the authors). Likewise the earnings from saving are not taxed additionally.[15] Besides this is one of the aims of such a combination.

4. While the proponents of the "supply-side economics" insist only on decrease in progressivity, the proponents of the Flat Tax plead for a single tax rate. Their logic, if consequently brought to an end, should exclude any tax relief. According to Hall and Rabushka "each cut in the top bracket ("flattening") moves the norm of fairness closer to its historical meaning of horizontal equity",[16] although defending their preservation. In this sense they are more-conservative and closer to the classics of the XIX century.

Is the original Flat Tax proportional or progressive? According to the prevailing current view of progressivity "a tax is progressive, if the tax/income ratio rises with increasing income".[17] From the formal point of view, in order to fulfill this condition the exemption threshold for each taxpayer is sufficient. But at one single tax rate with rising income, progressivity fades out, i.e. it is well illustrated in the bottom of the tax scale. For the high incomes the tax is almost proportional. In this sense it is true to say, that the Flat Tax has some elements of progressivity. There should be "introduced one or two additional higher marginal rates on the well-off to ensure that the degree of progressivity would not fade too rapidly with rising income".[18]

Everything mentioned above clarifies, that the Flat Tax is conceptually and practically closest to the "supply-side economics", especially as far as income taxes are concerned. It is a follow-up for further radicalization, "flattening" and simplification. At the same time the scope of this concept is more specific.

There are practical evidences, that the interactions in macroeconomics are much more elaborate, and the expectations of the "supply-siders" – rather optimistic. A lot of empirical studies have confirmed, that the link between labor supply and the reduction of the marginal tax rates is vague, and sometimes lacking. The evaluation of the elasticity of the net income supply equal to 0.15 is considered satisfactory. The reaction of the so-called primary employees is the weakest, and the elasticity of the less qualified secondary employees (married women, young people, pensioners) is stronger. The taxes have different effect on different professional and income groups.

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[15] *Hall, R. and A. Rabushka*. Op. cit., p. 82.

[16] Ibid., p. 43.

[17] *Musgrave, R. и P. Musgrave*. State Finances – theory and practice..: Отворено общество, 1998, p. 280; *Аткинсон, А. и Дж. Стиглиц*. Лекции по экономической теории государственного сектора. Москва: Аспект-Пресс, 1995, p. 49-50.

[18] *Zee, H.* Op. cit. p. 15.

It is also evident, that the decrease in the marginal tax rates does not result in a considerable economic growth, to extend the tax base and to set off the tax revenues. Many social costs were cut in order to influence the labor supply. Nevertheless the budget deficits and the government debts were increased. There was no “Tax revolution”. The progressions were elaborated again (in UK – 3 tax brackets with 10, 23 and 40% for the 1999-2000 fiscal year, in USA in 1993 – 6 tax brackets – between 10 - 39%, at the time of George Bush – up to 35%).

Worse results were achieved from such tax reforms in the developing countries and in the transition countries from planned-directive to market economy. “A few evidences are available (in general) for significant improvement of the revenues from personal income tax, ensuing from the reduction of the top marginal tax rates.”[19] Any further decrease in the top marginal tax rates would entail a drop down of the budget revenues. Tax compliance[20] can not be improved considerably, as long as the benefits from tax evasion are much higher than the expected sanctions, and the tax administration is weak. The savings of the population are much less (because it is much poorer), and the people save for safety’s sake. They are not affected by the rate of return after paying the tax. Moreover, as a rule the income from deposits is not taxable, and the capital markets and financial mediators are underdeveloped. Under the conditions of relatively high unemployment, one employed member of the family (in most cases) and the overall low living standard, the population has no other choice than full-time employment. Consequently just insignificant additional labor supply could be expected.

As far as the proposal for Flat Tax in USA is concerned, despite the support by some congressmen and senators both Republicans and Democrats, it can not be implemented in practice. When it was introduced in the House of Representatives, US Congress, known as Armey-Shelby tax proposal (HR 1040 of 1997), it was not accepted. The lack of sufficiently expressed vertical equity is identified as the main shortcoming of this concept: “The flat tax is unlikely to be able to achieve the level of progressivity embedded in the current income tax system, in particular by disallowing progressive tax rates to be applied to labor income, but also by excluding taxation of interest, dividends, and capital gains at the individual level.”[21]

Taxes of the “flat” type in Central and Eastern Europe

The Concept of Hall and Rabushka was rejected not only in the USA. It has not been introduced anywhere yet, but influenced the reformation of income taxation of nearly 20 countries worldwide, and is discussed seriously in 10 more countries. Their legislations however differ both from the original and from one another. Therefore we

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[19] For details: *Stepanyan, V.* Reforming Tax Systems: Experience of the Balthics, Russia and Other Countries of Former Soviet Union. IMF WP/03/173, p. 4-9, 22-25.

[20] Pursuant to the International Bureau of Fiscal Documentation – Amsterdam “tax compliance” is “the degree of reaction by the taxpayers to their lawful obligation to declare their income for the calculation of the respective tax and to pay it in time” (International Tax Dictionary. C.: “Svetulka-44” Publisher, 1995, p. 310).

[21] *Dalsgaard, T.* US Tax Reform: An Overview of Current Debate and Policy..., p. 17-18.

call them taxes of the "flat" type (see Table). We shall provide an overview of four countries from Eastern and Central Europe, being of interest to be compared with Bulgaria and for which detailed data are available.

Table

Main countries, having introduced taxes of the "flat" type and their key parameters

Country	Date of introduction	Tax rate (%)	Tax base (taxable income)	Available / not available tax relief
Estonia	1.I.1994 2009	26 20	Personal + dividends	Yes
Latvia	1997	25	Personal + (until 2000) corporate	Yes
Lithuania	1995 2000	33 24	Personal + (since 2000) corporate	Yes
Russia	1.I.2001	13	Mostly Personal	Yes
Serbia	2003	14	Personal + corporate	
Montenegro	1.VII.2007	15		Yes
Ukraine	2004	13	Personal	Yes
Slovakia	2004	19	Personal + corporate	Yes
Georgia		12		Yes
Romania	1.I.2005	16	Personal + corporate	Yes
Kyrgyzstan	1.II.2006	10	Personal + corporate	Yes
Macedonia	2007 2008	12 10	Personal + corporate	Yes
Mauritius	1.VII.2009	15	Personal + corporate	
Mongolia	1.I.2007	10	Personal	Yes
Guernsey Island (British Crown dependency in the Channel Islands)	1.VII.2006	20	Personal – above 1.25 mln. £ - digressive	
Czech Republic	2008	15=23.1	"Super gross" personal	Yes
Bulgaria	1.I.2008	10	Personal (for self employed (ET) – 15%)	No

Source: Hall, R. and A. Rabushka. The Flat Tax, p.VII-XIII; IMF WP 08/52; IMF WP 05/133; IMF WP 05/16; IMF WP 03/173.

In 1994 *Estonia* was the first to enact such type of tax, effective both for personal tax, and corporare tax at 26% of taxable incomes. It should be noted, that in each of the three Baltic states the tax base on personal income is very wide (including also pensions). For the period 2004-2009 the tax rate stepped down gradually to 24, 22 and 20%. In 2000 the undistributed profit was exempted from tax, and taxes are levied only on dividends. At the same time for the period 1994-2006 the monthly tax-free allowance for a tax payer stepped up from 300 to 2000 EST, or about 6.75 times (in EUR – from 19.2 to 129.6 EUR).[22]

[22] Calculated pursuant to the Transition Report 2003. London: EBRD, p. 140.

At the start of 2001, *Russia* unified its marginal rates of personal income taxation – previously 12, 20 and 30% - at the flat rate of just 13%. The tax-free level of personal income was increased nominally by 51.5% - below 4800 Rubles, by 30% in real terms and by 12% relative to the average wage.[23] Some personal incomes are levied with 35% tax. The Corporate tax remains up to 35%, and since 2002 – 24%. In 2002 the dividend tax rate was lowered to 6% (from 30% down to 15% before), when the Imputation Credit was eliminated. A very important "secondary" factor is the reform of social insurance payments. Prior to 2001 they were imposed at the rate of 1% on the employee plus 38.5% on the employer, and after the reform the employer was charged with a single tax at marginal rates decreasing from 35.6% (for income up to 100 thousand Rubles per year)., 20% (up to 300 thousand/year), 10% - (up to 600 thousand) to 5% (from 2002 reduced further to 2%) – with lowest marginal applying for salaries in excess of 600 thousand Rubles. This is a considerable incentive for "casting light" on the incomes. An important factor in this sphere is also the strengthened legal power of the tax authorities in 1999 and 2002.

In general, the available data are insufficient and not always trustworthy. It is also difficult to isolate the effects of the reform of PIT patterns and arrangements as well as the other reasons. The results in Russia at first glance seem striking. In 2001 the revenues from the PIT, in nominal terms, grew by 46%, and in real terms – by 26%, relative to GDP – from 2.4 to 2.9%, i.e. by about 20.8%, and 2 years later –up 3.4% of GDP. The after-tax real wage income grew by 18.5%, while gross wages grew more slowly (at only 11.6%), reflecting the reduction in tax rates. Still, both gross and net wages outpaced the GDP growth, which amounted to 5.1%, the average labor productivity, that grew only by 2.3% in 2001, implying an increase in the labor share aiming to recover to the wage level prior to the 1998 crisis. It was possible, because in Russia 1/3 of the revenues are related to the natural gas and oil prices. The share of the Illegal wages is relatively stable – between 9 and 12% of GDP, while year by year the legal wages "fluctuate"– between 29 and 39% of GDP.

Actually the average effective PIT rate increased slightly from 11.2 to 11.8%, but the average effective rate of the social taxes dropped markedly from 35.8 to 30%. Overall the average effective tax rate decreased by only 2.5%, i.e. much less, than it seems at first glance from the PIT and social taxation brackets. There is a modest gain in compliance: 72.4% of the total wages were officially reported to the tax authority, rising to 74 %. Moreover, if the revenue from PIT increase by 0.5% of GDP, the revenue from social taxes shall drop down in the same rate (from 7.7 to 7.3% of GDP). It is considered, that part of the increased revenues from PIT is due to transfer of income from the remaining high profit taxes and dividends to PIT. About 2% of the effects are due to the elimination of exemptions. Despite the "stimuli" the end-year employment increased only by 1.3% and year average

[23] Here and below *Ivanova, A., M. Keen and Al. Klen*. The Russian Flat Tax Reform. IMF WP 05/16.

employment only by 0.3%. The crucial conclusion of the authors is, that there is no evidence of a sustainable effect on supply.

In *Slovakia* the introduction of a tax of the “flat” type is a part of the comprehensive budget reform (being the first stage of the taxes and social benefits, especially social welfare). It is associated with the full EU membership (1.I.2004)[24] and the required fiscal consolidation in order to reduce the fiscal deficit below 3% of GDP by 2007, meeting the Maastricht criteria. The tax reform was designed as neutral regarding budget revenue and social security expenditure, but the EU accession and the introduction of the Second II Pillar to the pension system increased the tension.

The total revenues of the consolidated state budget dropped from about 33 down to 30% of GDP (intended 31%). The personal income tax was foreseen to be reduced by 1.4% (1.2% on the employees and 0.2 on the self-employed), and with the taxation of the dividends – 1.2%, but actually due to the high growth of GDP and the wages it is 0.8%, and with taxation of dividends – 1.1 %. The social contributions instead of the foreseen 0.8% were reduced by 1.0%. The indirect taxes were expected to rise by 1.8-1.9% of GDP, but actually grew by 1.4% (VAT – 1.2%, excise taxes – 0.2% instead of 0.5%, and customs duties dropped down by 0.2% instead of 0%).

Social security contributions payable on wages, were also reduced by 2.4% (to the amount of the wages), while the employee social contributions were increased by 0.6%, and those of the employer social contributions dropped down by 3%. The ceiling for payment of social security charges was increased from about 2 to 3 wages. The reform of the First I Pillar of the pension system began in 2004 and provides for gradual increase in the retirement age to 62 years (currently – 60 years for men and 57 or less – for women). On 1.I.2005 the introduction of the so-called Second II Pillar began. Most income tax exemptions were eliminated, and some low taxes were abolished. In general the tax burden was shifted from direct to indirect taxes, facilitating the efficiency of the tax system and capital formation. The tax burden on capital income dropped down below the EC average, including the neighbors (Hungary and Austria). It is expected to promote foreign investments.

The social assistance benefits were cut by 0.6% of GDP. The work incentives (from the decrease in the tax burden) are estimated as limited – mainly for high-income groups. The labor supply for from low-income groups is also promoted, but by canceling the social assistance benefits (especially for the families with 4 and more children) being linked to labor participation.

In general, the implications from the introduction of the Flat Tax in Slovakia are difficult to differentiate from the complete course of the reforms. The main effects are the increased horizontal equity, simplified administration, transparency and clarity.

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[24] Here and below - *Moore, D*. Slovakia’s 2004 Tax and Welfare Reforms. IMF WP 05/133.

In the beginning of 2008 the *Czech Republic* also introduced personal income tax of the "flat" type as a integral part of a broader tax and budget reform.[25] As the coalition government holds just ½ of the places in Parliament and there are internal disagreements, reflected in the radical nature and the economic effectiveness of the reform. A 15% flat tax was introduced on the "super gross" wage base [gross wage =1 + (0.35 + 0.125) – health and social contributions], corresponding to 23.1% on the gross wage, replacing a progressive tax rate scale of 12, 19, 25 and 32%. The joint taxation of married couples was abolished (to increase the work incentives). The tax credits for the tax payers were enhanced – 3.45 times (up to CZK 24.84 thousand per year). Tax credits for employed pensioners were introduced (higher labor supply.) The tax credit for an unemployed partner was increased 5.91 times, for disabled people – 1.68 times, with a higher differentiation in degrees, and a tax bonus per child – 1.78 times – up to CZK 10.68 thousand per year.

The corporate income tax rates will remain different from the personal income tax rates, with phased reduction from 24% in 2007 down to 19% in 2010. The taxes върху interest rates and dividends are maintained and equalized (15%). Thus the marginal tax rate on capital income will be reduced gradually from 32.8 to 31.2% in 2010, and on labor income – (1 + 0.35).0.15 + 0.125 employees' contributions – to total 32.8%. The new "ceilings" for social contributions of the employees and self-employed are at 4 times the average wage (previously the cap for self-employed was about 2 times the minimum wage). The key amendments in indirect taxes are the increase in the lower rate of VAT from 5 to 9% (expected 0.6% of GDP revenues) and increase in the excise tax on cigarettes.

There are numerous restrictive measures on the expenditure side, designed to limit the budget deficit (in the long run the budget balance should be improved by about 4% of GDP). Consequently all social benefits (except for pensions) will cease to be automatically indexed. The regular child benefit is limited to 2.4 times the minimum living standard (previously - 4 times MLS), and the additional – to 2 times (previously – 2.2 times). The maternity and parental benefits will be streamlined or eliminated and the unemployment benefits will be tightened. The sickness benefits for the first 3-7 days were abolished or canceled. User fee was introduced for doctor's visits and prescriptions. Increasing the retirement age and extending the qualifying period of years of work, cutting in government staff and temporary freezing of wages until 2010 are current topics of discussion.

The high-income earners benefit most of the reform. Some measures are controversial. Moreover, in the Czech Republic the increase in the indirect taxation on the account of the income taxation and the social and medical contributions is considered effective from structural point of view (better tax structure and reduced distortions).

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[25] The data for the Czech Republic are from the paper from *Dalsgaard, T.* Tax and Welfare Reforms in the Czech Republic. Structural Implications and Challenges. IMF WP 08/52.

The other countries with personal income tax of the "flat" type have introduced it at different time. The personal and corporate income tax are equal in Serbia, Romania, Macedonia, and different in the Ukraine, Lithuania, Latvia.

The total effect from the introduction of taxes of the "flat" type seems restricted. In most cases the revenues are lower (except for Russia, due to the rapid growth of incomes). The impact of the flat tax could be hardly differentiated from the impact of the other factors (especially from the reduction of the social security burden). The aggregate effect of the complete set of changes, incl. the budget expenses, sometimes reinforces the directly reduced differentiation at taxation (the Czech Republic). The "stimuli" to labor supply, savings, investments, transparency and compliance are moderate. They refer mainly to simplification of the tax systems. Hence they are not quite different from the impact of the reforms in the spirit of the "supply-side economics", being a logical follow-up.

Personal Income Taxation with a tax of the "flat" type in Bulgaria

In August 2007 the leaders of the governing triple coalition took a political decision to introduce such type of tax from the beginning of 2008. This idea used to be disseminated by comparatively narrow circle of economists and businessmen (issuing the "Flat Tax" Bulletin), related mainly with the private R&D centers. The characteristic features of this "right tax of the left government" turned out to be as follows:

1. Minimum rate – 10% on personal income (except for sole traders). The "tax dumping" idea could be perceived here (similar to the same intentions for the corporate tax and the social security and health contributions), i.e. encouraging natural persons having double or foreign citizenship to pay all or a fraction of their taxes due in Bulgaria.

2. The intentions were not a income-neutral tax, but increased revenues. According to the preliminary calculated revenues for the year 2007 at a rate of 2.6% of GDP and actually of about 3.2% for 2008, the expected revenues were 3.5% of GDP, or by 9% more in real terms.

3. Unlike the above-mentioned countries for this purpose the basic tax relief has not been increased neither nominally, nor really, but it was abolished completely. The available, although minimum, tax relief for the first three children in a family was also abolished. The opportunities for some donations were also restricted, as well as almost all the regulatory provisions for incremental costs. However the opportunities were maintained for considerable tax relief for personal voluntary social security and insurance contributions, as well as for voluntary health insurance contributions (Art. 19, para. 1 and 2 of the Law on Income Taxation for Natural Persons).

4. The sole traders are levied with a higher tax rate – 15%, closer to the profit tax – 10% corporate tax plus 5% on the dividends, or total up to 14.5%. Depreciation and interest rates are treated in the traditional way, investments too (in principle).

5. A relatively narrow Tax Base was remained (not considering the lack of tax-free minimum income) for the personal income compared to the other OECD and EC member states. The pensions, agricultural income, many in-kind benefits, the income from interest, gambling and awards are not taxable, resulting in paradoxes, in gross violation of the horizontal tax equity. For instance whereas the wages (even minimum wages) are taxable (BGN 220 per month for 2008 and BGN 240 per month for 2009 respectively), but the income from pensions – up to BGN 490 for the First I Pillar (BGN 700/month since April 2009) are nor taxable.

6. Since the beginning of 2009 a tax relief was enacted for interest on mortgages for residences, but only for legally married couples with age restrictions, i.e. in a discriminated and not clarified way.

7. A lot of excise taxes (fuels, cigarettes) were increased. The aggregate social and medical security burden dropped down considerably, being further transferred to the wages, and since 2009 – on the state as well. Since 1 X 2007 the total social security and health contributions were cut by 3%, and since the beginning of 2009 – by additional 2.4%, whereas the relief is completely in favor of the employers. The “ceiling” for the social security income stepped up considerably – from BGN 1400 to BGN 2000/per month for 2008-2010., and for 2009 the increased health contribution from 6 up to 8% neutralized a part of the total decrease. This is a sign of internal lack of coordination, contrary to the “flattening” concept. Nevertheless the total security burden dropped from 36.0 down to 30.6% of the gross wage, and averagely just 41.3% thereof, i.e. 12.64% is on the entrepreneur (burden 2 - 3 times lower than on the entrepreneurs in the other European countries). Therefore the policy in terms of the social and health security contributions should facilitate the transparency and “compliance” of payment of the personal tax.

According to the preliminary data, the tax collected for 2008 shall reach BGN 1990 mln. out of the envisaged BGN 2190 mln., or nominal rate of 90.9%. In real terms it means 3.0% of GDP at planned 3.5%, i.e. 85.7%. Apparently “bringing to light” (bringing a large portion of income from the informal sector into the tax net) of the incomes has not been achieved, and the non-compliance could be explained mainly with switching over to the illegal economy by some incomes. As the broadening of the tax base resulted in increase of about 800 mln. BGN for 2008 (2009 – 860 mln. BGN), the total loss of revenues from the replacement of the progressive tax (0, 20, 22 and 24%) exceeded BGN 1 bln., if taking into consideration the “gift” of BGN 800 mln. by the well-off and especially by the better-off on the account of the poor taxpayers. It should be noted, that it is the personal income tax, if being progressive and with non symbolical share/portion of GDP, that makes the entire tax system progressive. The high excise taxes and the “ceiling” of the social and health security contributions of BGN 2000 per month, combined with the 10% tax, make really the tax system in Bulgaria regressive, i.e. it intensifies the deep and in most cases unsubstantiated social differences. Moreover, the required tax relief for the first two children in the family was eliminated, instead of being extended.

Key conclusions and recommendations

1. The Flat Tax Concept of Hall and Rabushka, changing radically the personal and corporate income taxes has not been implemented anywhere in the world. The most radical changes therein refer to corporate income taxation, rather than personal income taxations. The original Flat Tax has some elements of progressivity for personal incomes due to the introduced considerable tax reliefs, although suggesting a single tax rate on the entire consumption in economy.

2. The taxes of the "flat" type, applied mainly in Eastern Europe, differ considerably from the original, being not so radical regarding the corporate income taxation. CIT remains independent, most often with a different tax rate from PIT. They also differ from each other not only in terms of rate, but also in terms of their cohesion with the other components of the tax systems, as well as with the social welfare systems. These taxes also include considerable relief. Usually they result in lower revenues from personal incomes, and unfavorable redistribution of the the tax burden in favor of the well-off tax payers.

3. Although the results of reforming the personal income taxation are difficult to be differentiated completely from the impact of the aggregate reform "packages", all the data and authors point out, that considerable improvements of the efficiency of the "Laffer type" can not be expected. In general the positive aspects are limited and make the tax collection procedure more transparent, simple and cheaper.

4. The Bulgarian personal income tax of the "flat" type is radical, exceeding the original in terms of personal incomes and leading to liquidation of any component if vertical tax equity not only therein, but in the entire tax system as well. It does not provide for horizontal tax equity either. The introduction of the tax could be explained with the impact of the interests of professional societies, rather than macro-economic decision-making considerations. The specific tax structure, macroeconomic and demographic situation make this type of tax especially unsuitable.

5. Other, more suitable patterns could be applied in order to meet the regulatory and fiscal objectives of taxing personal income, as well as competitive taxing of capital income in the international context. In the USA such models are: "Option 5" (year 2002), proposed by the Finance Department and the more radical X-tax of D. Bradford and the so-called US-tax (unlimited term deposits). Would be more suitable, under the conditions in Europe, incl. Bulgaria, the so-called dual income tax, matching the proportional low taxing of corporate incomes with the progressive taxing of personal incomes, with regulation functions. Variations of this model have been applied successfully in the countries in Northern Europe.

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