

Title: *The flat-tax revolution* , Economist, 00130613, 4/16/2005, Vol. 375, Issue 8422

Database: *Business Source Elite*

Section: Leaders

The flat-tax revolution

Fine in theory, but it will never happen. Oh really?

THE more complicated a country's tax system becomes, the easier it is for governments to make it more complicated still, in an accelerating process of proliferating insanity--until, perhaps, a limit of madness is reached and a spasm of radical simplification is demanded. In 2005, many of the world's rich countries seem far along this curve. The United States, which last simplified its tax code in 1986, and which spent the next two decades feverishly unsimplifying it, may soon be coming to a point of renewed fiscal catharsis. Other rich countries, with a tolerance for tax-code sclerosis even greater than America's, may not be so far behind. Revenue must be raised, of course. But is there no realistic alternative to tax codes which, as they discharge that sad but necessary function, squander resources on an epic scale and grind the spirit of the helpless taxpayer as well?

The answer is yes: there is indeed an alternative, and experience is proving that it is an eminently realistic one. The experiment started in a small way in 1994, when Estonia became the first country in Europe to introduce a "flat tax" on personal and corporate income. Income is taxed at a single uniform rate of 26%: no schedule of rates, no deductions. The economy has flourished. Others followed: first, Latvia and Lithuania, Estonia's Baltic neighbours; later Russia (with a rate of 13% on personal income), then Slovakia (19% on personal and corporate income). One of Poland's centre-right opposition parties is campaigning for a similar code (with a rate of 15%). So far eight countries have followed Estonia's example (see pages 69-71). 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.

Pure and applied

Practical types who said that flat taxes cannot work offer a further instant objection, once they are shown such taxes working--namely, that they are unfair. Enlightened countries, it is argued, have "progressive" tax systems, requiring the rich to forfeit a bigger share of their incomes in tax than the poor are called upon to pay. A flat tax seems to rule this out in principle.

Not so. A flat tax on personal incomes combines a threshold (that is, an exempt amount) with a single rate of tax on all income above it. The progressivity of such a system can be varied within wide limits using just these two variables. Under systems such as America's, or those operating in most of western Europe, the incentives for the rich to avoid tax (legally or otherwise) are enormous; and the opportunities to do so, which arise from the very complexity of the codes, are commensurately large. So it is unsurprising to discover, as experience suggests, that the rich usually pay about as much tax under a flat-tax regime as they do under an orthodox code.

So much for the two main objections. What then are the advantages of being very simple-minded when it comes to tax? Simplicity of course is a boon in its own right. The costs merely of administering a conventionally clotted tax system are outrageous. Estimates for the United States, whose tax regime, despite the best efforts of Congress, is by no means the world's most burdensome, put the costs of compliance, administration and enforcement between 10% and 20% of revenue collected. (That sum, by the way, is equivalent to between one-quarter and one-half of the government's budget deficit.)

Though it is impossible to be precise, that direct burden is almost certainly as nothing compared with the broader economic costs caused by the government's interfering so pervasively in the allocation of resources. A pathological optimist, or somebody nostalgic for Soviet central planning, might argue that the whole point of the myriad breaks, deductions, allowances, concessions, reliefs and assorted other tax expenditures that clog rich countries' tax

systems--requiring total revenues to be gathered from a narrower base of taxpayers at correspondingly higher and more distorting rates--is to improve economic efficiency. The whole idea, you see, is to allocate resources more intelligently. Yes, well. Take a look at the current United States tax code, or just at one session of Congress's worth of tax-gifts to favourite constituencies, and try to keep a straight face while saying that.

They cannot be serious

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.

It is true that the flat-tax revolutionaries of central and eastern Europe are more inclined to radicalism than their politically maturer neighbours to the west and across the Atlantic. Mobilising support for sensible change is far harder in those more advanced places--but not impossible. In tax reform, as 1986 showed, the radical programme can suddenly look easier to implement than the timid package of piecemeal changes. Now and then, the bigger the idea, and the simpler the idea, the easier it is to roll over the opposition. The flat-tax idea is big enough and simple enough to be worth taking seriously.

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