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**DOCTOR'S THESIS**

**Efficiency of the flat tax in the European Union countries**

**- SUMMARY -**

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## TABLE OF CONTENTS

<b>INTRODUCTION</b> .....	6
<b>CHAPTER 1. THE FLAT TAX IN THEORY AND PRACTICE</b> .....	18
1.1. Brief history of the income tax and the flat tax .....	18
1.1.1. History of the income tax on the payment capacity line.....	19
1.1.2. Refining the capacity to pay the income tax .....	30
1.2. The flat tax in the theories of economists .....	34
1.2.1. Progressive taxation in the economic thinking .....	34
1.2.2. Proportional taxation in the economic thinking .....	37
1.2.3. The flat tax theory of R. Hall and A. Rabushka .....	41
1.2.3.1. The basic pattern of the flat tax .....	43
1.2.3.2. Criticism and appreciation to the basic model of the flat tax.....	50
1.3. Definition of the flat tax .....	53
1.4. Diversity of flat systems adopted in the European Union and Russia .....	56
1.4.1. Commonalities and differences between the flat systems introduced in Europe and Russia .....	57
1.4.2. Flat tax systems introduced in the European and Russian countries.....	60
1.5. Conclusions, personal contributions, proposals for further development.....	74
<b>CHAPTER 2. EFFICACY OF THE FLAT TAX IN THE EU COUNTRIES, THE CURRENT STATUS OF THE RESEARCH</b> .....	76
2.1. Definition of the flat tax .....	76
2.2. Information sources expressing effectiveness .....	81
2.2.1. Empirical research based on real situations .....	81
2.2.2. Empirical research based on simulation .....	84
2.3. Efficacy in terms of revenue brought to the state budget .....	87
2.4. Efficacy in terms of fiscal discipline .....	97

2.5. Efficacy in terms of simplicity of administration .....	99
2.6. Efficacy in terms of simplicity of labor stimulation .....	103
2.7. Effectiveness of the flat tax in terms of social inequality.....	109
2.8. Effectiveness of the flat tax in terms of direct foreign investments.....	116
2.9. Efficacy of the flat tax in terms of automatic stabilizer .....	124
2.10. Conclusions, personal contributions, proposals for further development .....	133
<b>CHAPTER 3. FLAT TAX EFFICIENCY IN TERMS OF EXPANSION.....</b>	<b>136</b>
3.1. Dual taxation system, refining the capacity of payments and expansion of the flat tax.....	138
3.2. Constituents of the personal income tax in the EU countries.....	144
3.2.1. Income from employment.....	146
3.2.2. Income from capital.....	150
3.3. Comparative analysis of the flat rate extension in the EU countries.....	155
3.3.1. Research methodology.....	156
3.3.2. Database.....	160
3.3.3. Research results.....	161
3.4. Flat tax versus progressive tax.....	163
3.5. Conclusions, personal contributions, proposals for further development.....	168
<b>CHAPTER 4. CONCLUSIONS, PERSONAL CONTRIBUTIONS, PROPOSALS FOR FURTHER DEVELOPMENT.....</b>	<b>170</b>
4.1. Conclusions.....	170
4.2. Personal contributions.....	176
4.3. Proposals for further development.....	178
<b>REFERENCES.....</b>	<b>179</b>

### **Key words**

Flat tax, progressivity, proportionality, general principles of taxation, efficacy, fiscal discipline, work stimulation work, social inequalities, administrative simplicity, foreign direct investments, automatic stabilizer, labor income, investment income, mobile income.

## Summary

Income taxation using the flat tax was and is the solution chosen by the governments of at least thirty-eight countries around the world. The main actor in spreading this tax system was Russia, which after the adoption of the flat tax in 2001 showed particularly good macroeconomic results and determined the public opinion, the researchers and the policymakers to look closely and seriously to a movement started at least fifty years before by much smaller and less important countries. Both Russia and Estonia, country which first introduced the flat tax in Europe in 1994, has done this due to strong leaders, aware of and followers of the liberal theories.

The spread of the flat tax in the European Union was determined by imitating the model offered by Russia and Estonia, initially and then by the model provided by each country to the detriment of empirical analyzes showing the impact of this kind of taxation on the national economies. This, and the lack of clear positive results in the few studies conducted, raises questions on the viability of the flat rate considering that its introduction in the Central and Eastern Europe countries is nothing more than a signal of the former communist countries, signal for going towards market economies and democracy. Once the signal received, the flat tax should be replaced with the existing progressive tax system established in all Western European countries. The flat tax, not only remains a major taxation system in the adoption countries, but expanding to a significant extent. This is certainly due to its capacity to fulfil an important purpose for this age, we are living in. What are the goals that may be pursued by the introduction of a taxation system and if the flat tax is effective in relation to these purposes are questions we provide an answer by placing the flat tax in the historical context to which it belongs.

### Current state of knowledge

The flat tax is a tax on personal income (1), with one marginal rate (2) and a basic deduction (3). The three elements allow defining the flat tax either as a tax proportional to the basic deductions or as a progressive tax with a single marginal rate and send us to understand the place and role of the flat tax to the theories concerning the income tax and the eternal debate about progressiveness or proportionality.

The flat tax usually perceived as a proportional tax is theoretically supported by neoliberal economists with its leading promoters, Frederick Hayek and Milton Friedman. Through his work *Capitalism and Freedom*, Milton Friedman is the rightful father of the modern flat rate. The

popularization and the detailing of the income tax system via the flat rate was made by Robert Hall and Alvin Rabuska. By their work *The Flat Tax* they have laid the foundation of a true theory of taxation, the flat tax theory, a tight system with the same taxation rate both of the personal and corporate income, applied as close as possible to the source of income, in fact, a consumption tax because of the treatment applied to investments and savings.

The increase of the fiscal discipline, boosting the employment and entrepreneurship, maintaining budget revenues, ease of their management are some of the positive benefits that theorists believe the flat tax may have.

Empirical research allowing these expectations to be checked are few considering the fact that twenty years have passed since the adoption by Estonia of this flat tax. Empirical research based on real situations are even less. Empirical research based on real situations are researches related to countries that have adopted the flat tax and analyze the impact of the flat tax starting from the data immediately before and immediately after the reform, trying to establish a causal relationship between the ratios corresponding to expectations and the flat rate. This category includes eight major studies of which most concern the reform of Russia dated 2001 and not by accident, but because this country has a micro -level database from which the consumer behavior can be extracted. This paper provides a summary of the empirical research based on real situations for which the available data were critical. The databases used are micro -level data obtained through household level interviews: Russian Longitudinal Monitoring Survey (RMLS), European Union Statistic on Income and Living Condition (EU-SILC), Household Budget Survey (HBS) or Estonian Labour Force Survey (ELFS). The methodology most often used was the "difference in differences" and Gini coefficient.

Empirical researches for the countries that have not adopted the flat tax were based on simulations by different models: EUROMOD, FiFoSiM, SloMod, general equilibrium models. Simulations relating to European countries, summarized in this paper, were generally focused on OECD countries, countries that consider adopting the flat tax or that sought to answer scientifically to the sympathy wave created for the flat tax. These simulations are based on various scenarios, where it is important to define the pair tax rate - personal allowances. The results provided by the simulations correspond to the results obtained by the research related to the reform "shock" with data immediately before and after the reform and also provide valuable information on the possibilities for improving the flat tax systems.

### **Research Goals**

Our research aims at evaluating the effectiveness of the flat tax in order to determine the place and the importance of this taxation system within income taxation. The effectiveness is measured based on the flat tax theorized benefits and expectations of the decision-makers for the European Union countries.

To achieve the general objective, the research assumptions are:

Assumption 1 The flat tax is a form of manifestation of the income tax corresponding to the current economic context.

Assumption 2 The flat tax is a taxation system in which the basic principles of taxation are refined.

Assumption 3 The flat taxation had a strong progressive nature.

Assumption 4 The flat tax is not effective as regards most of the proposed objectives.

Assumption 5 The flat tax is effective in terms of expansion.

Assumption 6 The flat tax has the potential to increase in importance.

### **Research Methodology**

This paper falls into the category of *non - experimental research*, the methods used in the research are the *descriptive* methods, with the aim to describe the current state of the flat tax.

Entering the flat tax in the historical context to which it belongs involves the use of the *historical research methods*, methods that require access to the primary and secondary sources of information. We have used tertiary sources, historical studies conducted based on the first sources, less authentic but which provide validity because of the authors' prestige. The exposure of the actual condition of the flat tax systems in the European Union countries was based on *case studies* of the countries involved and documented.

*Documentation* is the main method in developing the second chapter because of the destination of this section as synthesis of the research conducted and related theories. *The documentation* merges with the *archived data analysis* and *the correlation method* in chapter three. The followed indicators that depend on the years passing by, without the possibility of determining the causal link has led to the use of the experimental research trend construction.

### **Motivation and importance of the research**

The way income is taxed is important for the country's economy both at microeconomic and

macroeconomic level, while the concerns for understanding the positive or the negative effects of a particular tax system in view of optimization are always topical.

The income of the population with the two components of its mobile and less mobile revenues, raises serious questions about their taxation in the context of globalization. Knowledge and interpretation of the reality in terms of the past is very important for understanding the trends, acutely valid for income taxation. First, it is important that the tax systems are correctly designed, appropriately for the economic context, while the alternative is the additional reduction of the budget revenues and thus the growing weight to support the welfare state. Secondly, the identification of possible changes at the level of general principles generated by taxation can cause significant changes of the dependent areas: the extent of public expenditures, their structure and of the areas of dependency administrative systems, international cooperation. Flat tax due to the limited number of research is a topic whose development is topical with many research opportunities unexplored yet, some of them partly clarified in this paper.

#### **Structure of this paper**

This paper is designed in four chapters starting from placing the flat tax in its historical context, in the economic theories and the practical reality, continuously following the general principles of taxation in the first chapter. Chapter two, based on the existing research, highlights the low effectiveness, if not nonexistent of this taxation system, which is likely to raise questions regarding flat tax continuity. The answer is partially provided in chapter three that sheds light on the reality of the flat tax extension through the dual tax system, introduced in most European Union countries. In this chapter, as a result of the research results, we suggest the possible causes of this expansion and of the subsequent expansion or contraction.

Each chapter ends with a sub-chapter that includes the conclusions, the personal contributions and the proposals for further development and in the end these are grouped and completed in the fourth chapter.

By the descriptive and the historical research, **Chapter 1** validates the first three research assumptions indicating the flat tax as a form of manifestation of the income tax corresponding to the current economic context that allowed refining the basic principles of taxation and the shift to achieving progressivity via differentiated marginal rates in achievement of progressivity by personal differentiated allowances.

Following the historical income tax course, the paper highlights the actual causes of the transition from one form of taxation to another, i.e. changing the way of creating wealth and the forms of wealth. Over time the forms of wealth have changed, but the principle of taxation according to the ability to pay with horizontal and vertical equity remained valid. The flat tax in the countries it was introduced as a general tax system complies with these principles. The flat tax in the dual system of taxation no longer complies with it, as the labor income and the financial income are taxed differently; the first by progressive taxation and the second by flat taxation. The mobility of the revenue-generating capital has changed in the way of creating wealth. The adaptation to these mobile forms of taxation was achieved by refining the principle of ability to pay.

The flat tax, as a general income tax system differs from country to country, with a strong unique nature in some countries and progressive nature in other countries. The flat tax introduces progressivity through basic personal deductions based on the income or individuals.

**Chapter 2**, by descriptive methods and documentation, validates the fourth assumption, according to which the flat tax is not effective as regards most of the objectives proposed for evaluation

The effectiveness in the European Union of the flat tax system is crucial for maintaining this system or its abandonment, whether we speak of effectiveness in terms of the initially intended purpose, or efficiency based on objectives occurred over time.

The starting point of the second chapter is defining flat tax efficiency with a high degree of difficulty due to the need to define the desired effect. The expected effect was determined according to the possible advantages and disadvantages of this taxation system.

The efficacy of the flat tax was defined in terms of increasing / maintaining the budgetary income due to an improved collection and / or widening of the tax base and to stimulating labor, as well.

The bureaucracy and the fear of losing foreign investments came along with improving the tax collection, reasons for which the flat tax was adopted. Other variants of defining effectiveness were imposed ie, the effectiveness of the flat tax based on its ability to provide a simple administration and on the effectiveness depending on the level of foreign investments attracted.

The redistribution part, the social inequalities that a tax system can increase or, on the contrary, reduce require tracking the flat tax effectiveness in terms of social inequalities.



The tax system can be a macro stabilization lever through its ability of automatic stabilizer. Flat tax efficacy must be regarded in terms of contribution to the economy macrostabilization, which is important given the Stability and Cooperation Pact which reduces the possibilities for intervention in terms of deficit and spending.

If these goals were achieved or not, ie if the flat tax has proven effective or not, was followed by a comparative analysis of the types of research for each objective proposed and the theory related to the goal in question. The results obtained, and the reserves imposed both because of the small number of studies and the small number of countries examined, are summarized in Table 1.

Table 2.1. Efficacy of the flat tax in the European Union countries

Ref. no.	The proposed objective	Result
1	<b>Income to the state budget</b>	negative
2	<b>Fiscal discipline</b>	<b>poorly positive</b>
3	<b>Labor stimulation</b>	negative
4	<b>Simplicity of administration</b>	regardless
5	<b>Social inequality</b>	negative
6	<b>Foreign direct investments attracted</b>	<b>poorly positive</b>
7	<b>Automatic stabilizer</b>	negative

Source: the author

Comparative analysis of the three scientific elements: theory, empirical research and simulations, highlighted the objectives considered in determining the effectiveness which can be improved (work simulation and the automatic stabilizer), objectives for which the flat tax records negative results in all three points of view (social inequality), goals that should not be attributed to flat tax (simplicity of administration).

**Chapter 3** provides a partial answer to the uncertainty of the flat tax continuity in terms of lack of effectiveness of this tax system or in the conditions of reduced effectiveness.

Bringing to light the reality of the flat tax extension by the dual taxation system introduced in most European Union countries, our assumptions on the effectiveness of the flat tax in terms of expansion and possibility of extension are validated in this chapter. Through the research of reports issued by the tax consultancy authorities, PricewaterhouseCoopers, Ernst & Young, we have

highlighted the dual tax countries and have set the different levels of introduction of this system. The flat tax map per countries and degrees of intensity is the result of this approach and thus proves the geographic extent of the flat tax.

Given the separation in the dual system of taxation of the personal income into employment revenues mostly taxed progressively and financial investment income subject to flat taxation, we have demonstrated indirectly the growing importance of the flat tax at the expense of progressive taxation, by increasing the tax base related to flat tax and withdrawing the tax base related to the progressive taxation. Based on the literature and comparative analysis of the data available, the reality of the decrease in the labor income as a share of GDP and the increase in the financial income of the population as a share of the GDP brings to light the expansion of the income subject to the flat tax at the expense of the income taxed progressively, proving thus the quantitative expansion and not only the geographic expansion. The financial income of the population is interpreted by the financial assets ratio available to households. The comparative analysis based on waveforms and SLOPE ratio for each European Union country highlights the major group of countries in which the share of financial assets held by households in GDP increases at the expense of the labor income share and confirms the assumption that the flat tax becomes more popular and important. The two countries where the financial income continues to be taxed progressively, France and Britain, suggest the maturity of the financial market and the union power as ways enabling the change of the current situation of the flat tax.

**Chapter 4** is intended for general conclusions, personal contributions and suggestions for further development.

Proportional or progressive taxation of the personal income depended on the will of the decision maker supported by one theory or another of taxation in compliance with the general principles of taxation.

Proportional and progressive taxation of the personal income in violation of the general principles of taxation requires rethinking of theories so as to be generally applicable.

The proportional tax - progressive tax dispute seems to have shifted from volitional level in theory to practical – adaptive level.

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