

FLAT TAX SUSTAINABILITY IN THE EURO ZONE

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Abstract: *This paper explores the sustainability of the flat tax system in the conditions of euro adoption. Estonia and Slovakia are the only countries that experience both flat tax and euro. A comparative analysis of flat tax sustainability in Slovakia and Estonia offers the conclusion that the Romanian flat tax system is not sustainable from the perspective of the euro adoption criterion.*

Key words: *flat tax, euro zone, sustainability.*

1. Introduction

The flat tax “revolution” in the European Union seems to find its end in the current economic climate.

Slovakia and the Czech Republic, two of the eight European Union Countries that experienced flat tax system, replaced it in 2013 considering that a flat tax rate “does not have a place in this” (9). So Estonia remains the only one out of the sixteen countries from the Eurozone with a flat tax system.

A question arises: whether flat tax could be maintained under the condition of EMU adoption.

The sustainability of the flat tax has changed from the beginning of its European experience. Passing through two big economic crises (the bubble crisis and the debt sovereign crisis), the European Union sets strongest fiscal rules for its EMU members. This is the “world” mentioned by the Slovakian prime minister, Fico.

In Section 2 of this article, we review the economic literature about the sustainability of the flat tax system and show in Section

3 what has changed in the flat tax sustainability in Estonia, Slovakia and Romania, a country that ratified the Fiscal Compact in 2012. Section 4 treats supplementary challenges for the flat tax system under EMU conditions.

In the conclusion, we show that in Romania, the sustainability of the flat tax system is not valid, given the conditions of euro adoption.

2. Flat tax sustainability: a review

There is a rich literature about the advantages and disadvantages of a flat tax with a lot of adepts and enemies. Despite these large emulations, empirical analyses of the effects of a flat tax reform are very few. And fewer are the studies about the sustainability of this system even if we talk about fiscal sustainability, political sustainability or social sustainability.

The sustainability aspect of the flat tax system that is researched here does not have the classical economic meaning of sustainability. A single tax from the puzzle of a national fiscal system cannot count for sustainability.

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The term sustainability refers here to any reason that makes the flat tax system be installed, spread and maintained in the European Union.

As we know, Estonia was the first European country that adopted the flat tax system in 1994. The reason for its adoption was a policy champion, Estonia's prime minister, Martin Laar, as Aligica and Evans concluded in a Boolean study (1) too.

Indeed, although Martin Laar was advised of Milton Friedman and Hayek works, the decision was based on feeling. "That was only written in textbooks. I had faith that this was right, yes." (see [1]). The economic effects of flat tax introduction on the Estonian economy were incredible, but never analyzed.

The spread of the flat tax in Europe in accordance with the same Boolean study was based in principal on the precedent created by Estonia. In sixteen countries out of twenty, the precedent condition was present. In four countries, the precedent was the only reason.

Tax evasion, budget pressure and capital flight were the next conditions as importance for the flat tax adoption.

Tax evasion and budget pressure could be translated as countries with the biggest shadow economies. The former communist countries had "no real tax system", as Andres Aslund argues and most of Eastern European countries adopted a model of progressive taxation unfamiliar to them (2). Consequently, the flat tax promises of simplification and fiscal discipline seemed very attractive.

Indeed, the economic analysis of "The Russian Flat Tax Reform" (7) concludes with some reserve that the flat tax reform had a significant increase in tax compliance.

One can talk about the capital flight condition when there is a discrepancy between two neighbouring countries on the

incentive for individuals or firms investments. The competition between countries is reflected by the ratio of the exports to GDP and amounts of FDI. Competition was an important reason for flat tax adoption in eight countries out of twenty, according to the same Boolean study.

In our study, we refer to Estonia, Slovakia as the only flat tax and EMU countries and to Romania, a flat tax country engaged on the road to EMU.

As we have seen, Estonia, as a flat tax pioneer in Europe, had no concrete reason, but feelings. The sustainability of flat tax in Slovakia adopted in 2004 was more a social sustainability based on a strong civil society, on membership in International Community. A policy champion and the precedent complete the entire picture.

Romania experienced a policy champion and the precedent condition.

In conclusion the factors that sustain flat tax adoption were more circumstantial ones: feeling, precedent, lack of experience in fiscal system design. Fiscal competition remains as the strongest incentive for flat tax, but only at rhetorical level, having never been analysed.

3. Flat tax sustainability in practice

The flat tax system, as it was theorized by Alvin Rabuska, should have the whole sustainability in the world because such a system should be a growth and compliance stimulus for a national economy. As theory says (6), a flat tax system is an airtight consumption tax system with only two types of income, business income and wages, with the same rate of taxation.

This system is supposed to improve incentive to work, entrepreneurial activities and capital formation that will raise national output and standard of living.

In practice, the flat tax system was implemented in very different forms, and

differently from theory. No country adopted the flat tax system as it was proposed by Rabuska.

Feeling and precedent cannot be sustainable factors any longer for flat tax adoption or maintenance.

After almost ten years of fiscal system design experience, a government should carry on a more complex fiscal system. In fact, the complexity of a fiscal system is not given by the tax breaks, but the exemption and deduction. Once the elimination of some exemption was made under the flat tax, the future system should be less complex. Much more, for the countries that joined the European Union in 2004 or 2007, the related adjustment process awarded them the opportunity to redesign their tax systems according to the latest findings on growth-conduciveness.

Shadow economy does not depend only on the tax burden (10), but the increased regulation in the official economy, especially of labour markets; forced reduction of weekly working time; earlier retirement; unemployment; and the decline of civic virtue and loyalty towards public institutions combined with a declining tax morale.

In this respect, even though eastern and southern European countries have a lower overall tax burden (5) (Romania the lowest level of tax burden, Slovakia on the sixth place and Estonia on the twelfth out of 27 European Countries), they are on the top of the shadow economy as a percentage in GDP (11). Romania takes the second place following another flat tax country, Bulgaria, positioned on the first place. Estonia takes the fifth place out of 31 European Countries.

Taking into account the statistics presented above we cannot say that flat tax is a better fiscal system than a progressive one to reduce shadow economy.

What remains from the previous flat tax sustainability factors is foreign direct

investment.

It is said that flat tax was adopted to be a signal for foreign investors that the new governments of former communist countries switched towards a more market-oriented policy. This signal could be translated as Foreign Direct Investment flow.

It is said that flat tax system counts in the fiscal competition between European states. Fiscal competition remains the strongest factor that sustains the actual flat tax systems. When the authorities or journalists invoke this factor they do not relay on empirical analysis.

The period from 1994 to 2008 was the time of flat tax childhood, when no one knew if Rabuska's predicted results would be achieved. It was a period when one could not dispatch from a heating economy the positive effects of the flat tax implementation.

Indeed, the FDI increased in Estonia, Slovakia and Romania, but not necessarily after the flat tax adoption. 2004 was the year when Slovakia adopted flat tax. But FDI as a percentage of GDP increased sharply before the flat tax adoption and followed a slight decline after the flat tax adoption, Figure 1.

In Romania and Estonia, things are the same. As Bruce A. Blonigen reveals in his survey of FDI literature (3), the issues are complicated enough so that broad general hypotheses, such as taxes generally discourage or encourage FDI, simply should not be expected once one takes a closer look. Researchers did not agree on what causes FDI movement.

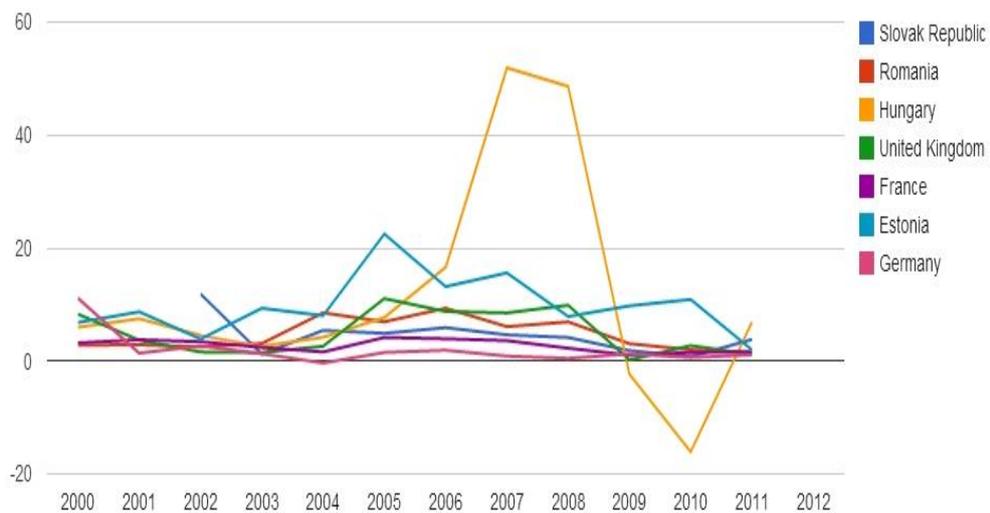
In this respect, without empirical analysis to follow, based on figure 1, we can assume that in the period 2003-2009 Estonia, Slovakia and Romania opposed a real fiscal competition to western European countries, attracting more FDI, but no clear cut dependence of flat tax introduction.

We can see that after 2008, fiscal competition on FDI has slowed in Estonia, Slovakia and Romania. FDI as a percentage of GDP for these countries comes closer with the other European Union countries. This reality gives us the idea that the economic boom counts more on increasing FDI in the flat tax countries than the flat tax itself.

None of the sustainable flat tax factors that have counted for its approval before have clear cut effects.

But a strong conclusion comes out from the few studies conducted: flat tax adoption decreases afferent public revenue.

Anna Ivanova et al. (7) have found out that there is no strong evidence that tax reform itself caused the PIT revenue boom in Russia. The 2001 Russian tax reform has been one of the most influential and widely emulated reforms of the previous years because of the very strong performance of PIT after the reform. Her analysis suggests that “the strength of PIT revenue in Russia 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”.



Source: TheGlobalEconomy.com, World Bank

Fig. 1. *Foreign Direct Investment, percent of GDP*

The work of Michael Keen et al. (8) makes clear the conclusion that, except for Russia, the second wave of low-rate flat tax reforms has been associated with a reduction in revenue from PIT.

4. Flat tax sustainability in the Euro Zone

The European Monetary Union is still a work in progress looking for the best

solution to sort out monetary and fiscal balance among the states and between states and the European Commission.

An important stage is represented by the Fiscal Compact signed by all member states of the European Union, except for the Czech Republic and the United Kingdom on 2 March 2012.

Romania has chosen to be bound by the fiscal provisions in the treaty even though

the pact refers to EMU countries.

The treaty defines a balanced budget as a general budget deficit less than 3.0% of the gross domestic product (GDP), and a structural deficit of less than 1.0% of GDP if the debt level is below 60% or else it shall be below 0.5% of GDP.

These conditions are the important aspects of today's fiscal policy in EMU countries in order to keep euro in balance. But the importance of fiscal policy lay on its capacity to address the cyclic fluctuation of the economy.

Even though in terms of fiscal sustainability Estonia does not appear to face short-term, medium-term or long-term sustainability challenges (4) with its 6.1% of GDP, the government debt in 2011, the flat tax policy has been clearly pro-cyclical, increasing government sector dependency on consumption, narrowing the tax base and limiting the scope of automatic stabilizer. Victor Transberg (12) argues in his work that the pro-cyclical tax was one of the major reasons that led Estonia to economic overheating and record-deep recession.

With its highest proportion of consumption taxes to total taxes in the EU, Estonia seems to be a good candidate to a future replacing the flat tax system.

The ruling coalition has fought to keep Estonia's 'flat tax' which is levied at 21% on both individual and corporate income, as the opposition Centre Party had campaigned to remove the flat tax and replace it with a progressive system of taxation. The ruling coalition bases its fight on the fact that flat tax is seen as important for maintaining business confidence in the country, but as it was showed in the previous section this effect in not clear cut.

Slovakia appears to face a risk of fiscal stress, according to the European Commission Fiscal Sustainability Report for 2012 (4) due to the budgetary impact of ageing costs reflecting a rapidly ageing

society, which has not been addressed in pension reforms prior to 2012. The government debt (43.3% of GDP in 2011 and expected to rise to 55.9% in 2014) is below the 60% of GDP Treaty threshold. The public deficit in 2012 was estimated at 4.6 of GDP.

The figure above and the lack of proved sustainability of flat tax determined the Slovakian government to scrap its 19 percent flat tax and replace it with higher taxes on the rich (25 percent), politicians (plus 5%) and corporations (23%). These measures were accompanied by an austerity package that included higher levy on banks and changes to the pension system.

In the same report, Romania appears not to face a risk of fiscal stress in the short run, but a low risk in a medium-term perspective and medium risk in the long term. The government debt (33.4% of GDP in 2011 and expected to rise to 34.8% in 2014) is below the 60% of GDP threshold. The public deficit (2.4 % of GDP in 2012) and the government debt should not raise questions about the removing of the flat tax system.

Romania seems to mix the problems of Estonia and Slovakia.

With the third highest reliance on indirect taxes in the EU as of 2010 (5), Romania has the same problems as Estonia: a pro-cyclical fiscal policy.

In terms of increasing government debt and age related expenditure, Romania is very close to Slovakia's situation.

The Romanian flat tax seems to be the happiest one on the road of EMU adoption, as the Romanian government debt and public deficit fulfil the Fiscal Treaty requirements.

But even though the economic literature and analyses are few in number, they have the same results. The flat tax system in the forms that was adopted did not fulfil the expectation, either of theoreticians or practitioners.

Romania would probably remove its flat tax system driven by the precedent if not by its efficiency.

5. Conclusions

The flat tax system experienced two interesting periods. One period was immediately after the fall of the communist regime and one in the economic bubble.

The adoption of the flat tax in the first period was a signal of the communist regime shifting towards a market oriented economy. This reason cannot be taken into account nowadays.

The adoption of the flat tax in the second period was based on different factors that cannot matter in these days any longer: the precedent, the policy leader, the civil society, the tax evasion and the budget pressure. As we have shown, fiscal competition is not a clear cut factor either.

None of the possible sustainable factors for a flat tax policy is clear cut and proved.

The European Monetary Union requests fiscal discipline for its member countries. The flat tax loses its first territories, Slovakia, under the Compact Treaty request.

If these requests are combined with the requests of a well designed fiscal system that is an automatic stabilizer, the flat tax will probably lose other territories: Estonia and Romania.

Notes

- 1] Transcript available here
<http://www.balticsworldwide.com/larr.htm>

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