a flat tax for the UK? the implications of simplification

AN ACCA DISCUSSION PAPER

A flat tax for the UK?
The implications of simplification

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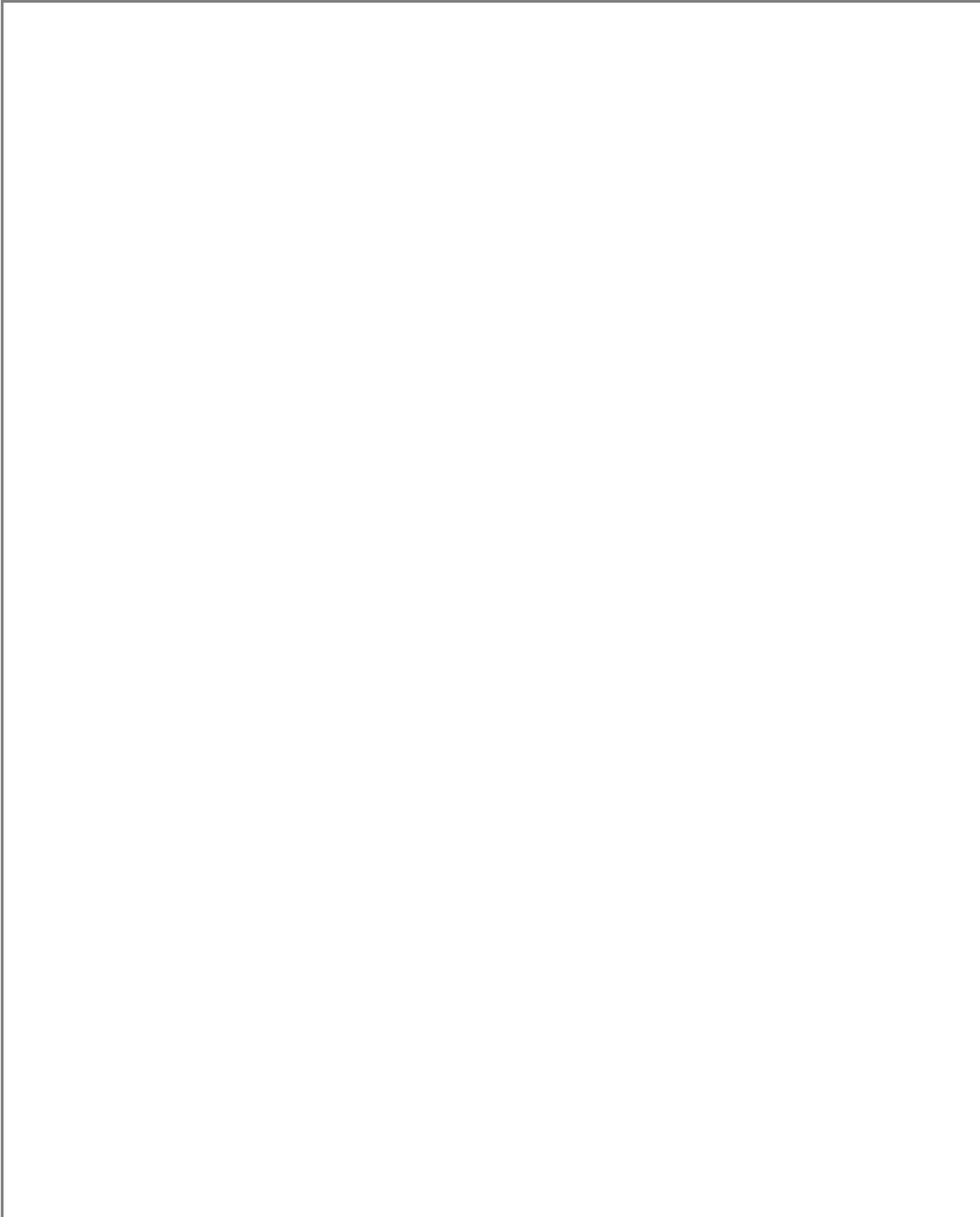

Executive summary

Flat taxes were rarely heard of in the UK before the mid 2000's. During the summer of 2005 they became an important subject for debate. Emerging for some as the panacea for tax simplification, while viewed by others as unfair, flat taxes are the subject of a complex debate in the UK as well as internationally. With a new proposal for a flat tax for the UK published in February 2006 (Heath 2006) the issue continues to be significant.

As policymakers seek to assess the viability of flat taxes, this report from ACCA discusses:

1. what flat taxes are
2. what benefits are claimed for them
3. what evidence there is to support the claims
4. what issues a flat tax might raise in the UK.

WHAT ARE FLAT TAXES?

According to the UK Treasury (2005), flat taxes are 'tax structures that have a single positive marginal tax rate'. Technically this could cover income tax, corporation tax on company profits or VAT and some are even suggesting such an arrangement should include national insurance. Most of the time though the taxes remain distinct and the term flat tax refers to a replacement for the existing income tax rules incorporating two key features:

1. an increased personal allowance
2. a single tax rate.

In some cases it is proposed that the same rate that is used for the flat income tax is also used for corporation tax, which is charged on the profits of companies. In practice, this is uncommon.

IS A FLAT TAX JUST A MATTER OF HAVING ONE TAX RATE?

Those who suggest flat taxes also suggest that all tax laws should be re-written at the same time. Such changes would change significantly the tax base on which tax is charged. Whereas in the existing income and corporation taxes it is all income (less expenses) that is charged to tax, under a flat tax regime only two sorts of income are taxed, namely wages and the cash surpluses of businesses. The rest of income is untaxed. As a result flat taxes are technically consumption taxes and not income taxes. This is because their tax base is in practice much closer to that of a VAT than it is to income taxes. In a flat tax system all income from capital (whether of gains or income derived from it such as dividends and interest) is tax free.

WHAT BENEFITS ARE CLAIMED FOR FLAT TAX SYSTEMS?

The main benefits that are claimed for flat tax systems are that they:

1. simplify the tax code
2. reduce the burdens on individuals who have to file tax returns
3. simplify business administration
4. cut the number of state employees who administer tax
5. reduce the number of taxpayers
6. reduce the tax rate
7. reduce the incentive for tax evasion, and cut or eliminate tax avoidance
8. increase the fairness of the tax system
9. stimulate the economy
10. provide increased incentives to work.

Whether these benefits have been found in practice is hard to answer as no country has adopted a 'proper' or truly flat tax system. According to the UK Treasury (2005), 'in all discussions on flat tax structures it must be remembered that the debate is in part so fierce because so little hard evidence exists to support the pro-flat tax claims'.

WHAT IS THE COST?

Flat tax systems in Eastern Europe have generally increased the tax take of the governments who have introduced them, although it should not be presumed that this is the consequence of the use of flat taxes. Most of the countries in question have undertaken so many changes that a cause for increased tax revenues cannot be identified with certainty. In addition, other economic factors, such as Russia having also enjoyed the benefit of a booming oil economy, have to be taken into account. Indeed, in some states such as Romania and Slovakia the increases in tax following creation of a flat tax system were from national insurance and VAT and not from flat taxes.

In Western countries like the UK it is generally agreed, even by flat tax proponents, that a flat tax will cut government revenues. That is in fact the intention of some who propose flat taxes, such as Alvin Rabushka, who co-invented the idea. The loss that has been estimated for the UK varies between £35 billion and £59 billion (Teather 2005).

The latest proposal for a flat tax for the UK considers that 40% of the loss it suggests likely (of the highest figure, of £59 billion) could be recovered by economic growth stimulated by a flat tax (Heath 2006). The rest would have to be covered by cuts in public spending.

THE ISSUES

A recent survey among SMEs in the UK suggests that the complexity of the UK tax system and the frequent changes that occur within it have helped create interest in flat taxes among this group (Tenon Group 2005). In the accompanying press release, however, it is warned: 'No one knows yet exactly what a flat rate tax system will look like…there are a number of dangers [and]… flat rate tax could quickly become as complicated as the current system…' (Tenon Group 2005).

The theory of flat taxes suggests significant simplification of the tax system; the assessment of those systems undertaken for this report suggests they may be as complicated for small businesses and individuals and require as much or more form filling as the current UK tax system. In addition, flat tax systems appear likely to impose costs on government and to redistribute incomes in ways that require political judgement to be exercised, an issue beyond the scope of this report.

In consequence, introducing a flat tax would not be a simple issue. The complex issues are discussed in detail in this report, which pinpoints key questions such as:

- What is the role of the state and of government in taxation and the management of the economy? How does opinion on this affect the design of a flat tax system?
- Should tax be charged on income or consumption in a flat tax system? If on income, should that from overseas and that from savings be taxed?
- The UK has complex rules on both residence and domicile. The latter is relatively unusual and believed by the UK to provide it with competitive advantage. Would this advantage be lost under a flat tax system?
- Most countries, including the UK, have many international double tax treaties and other obligations. To what extent should any tax reform be designed to meet such international obligations along with the needs of the domestic market?
- Should small business be treated differently from large business?
- How will trusts be taxed in a flat tax system?
- What is the future of inheritance tax? Can a flat tax replace it?
- What anti-avoidance measures are needed – and how should they be used in a flat tax system?
- Is it necessary to have only one tax rate to achieve simplicity?

Section A: The theory of flat taxes

Flat taxes were rarely heard of in the UK before the mid 2000's. During the summer of 2005 they became an important subject for debate. With a new proposal for a flat tax for the UK published in February 2006 (Heath 2006) the issue continues to be significant. The following issues are explored in this section:

1. **the theory of flat taxes**
2. **the claims made by those who propose flat taxes**
3. **the key changes in taxation that flat taxes would create**
4. **which countries use flat taxes and how their flat tax systems fit into their overall fiscal policy**
5. **what those who criticise flat taxes have to say on these issues.**

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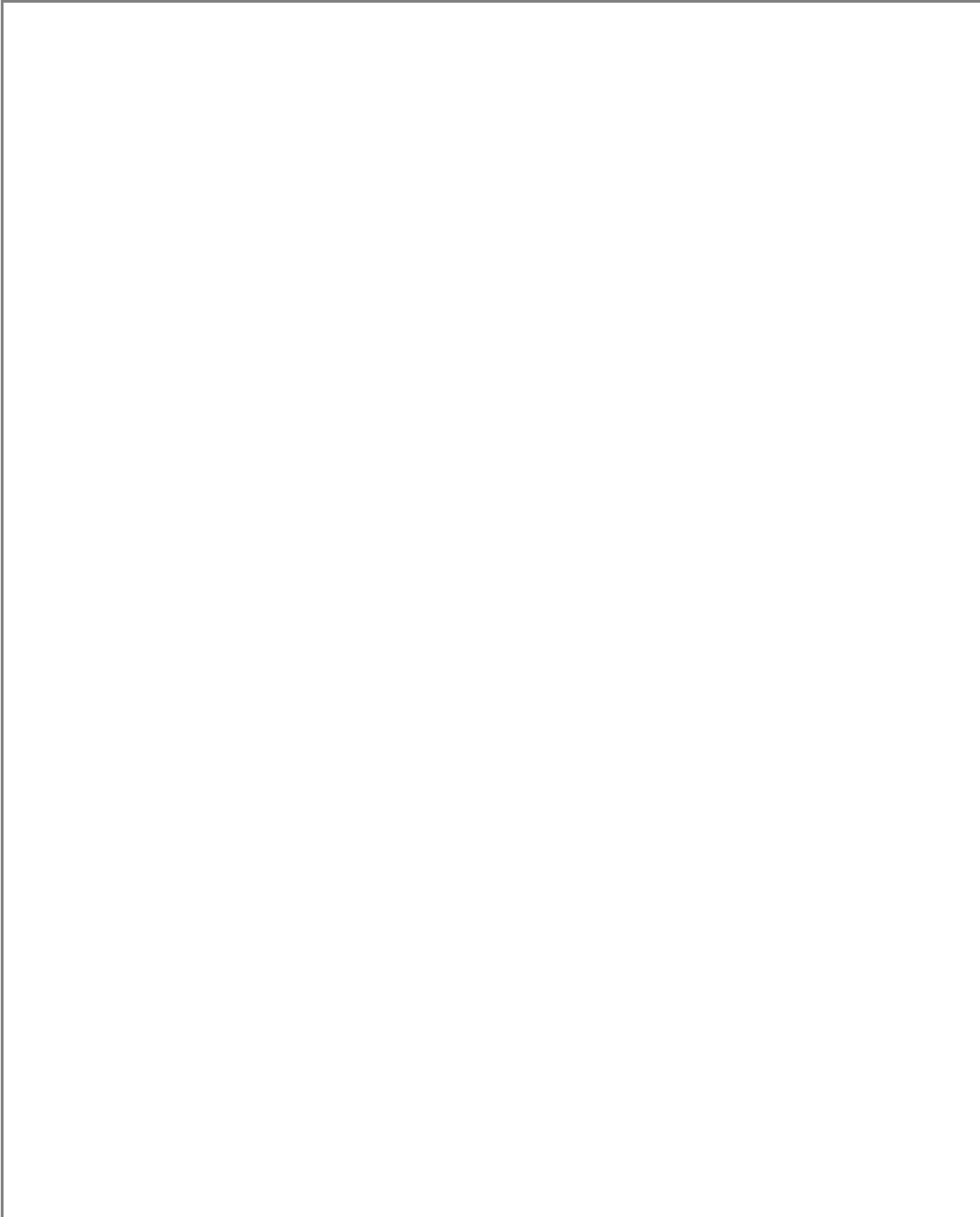

1. What is flat tax?

THE PEOPLE BEHIND FLAT TAX THEORY

Two names dominate the theory of flat taxes: Robert E. Hall[1] and Alvin Rabushka.[2] Both are academics at the Hoover Institution at Stanford University, who first proposed a flat tax in an article for the *Wall Street Journal* in December 1981. More detail is given in their book, *The Flat Tax* (Hall and Rabushka 1995).

The system of taxation that Hall and Rabushka propose has been given indefatigable support by Steve Forbes,[3] editor-in-chief of the business magazine, *Forbes*. He was a Republican candidate in the US Presidential primaries in 1996 and 2000, the flat tax being the main plank of his campaign (Forbes 2005:xvii). He continues to be the public figure most associated with the subject, most recently publishing a book, *Flat Tax Revolution* (Forbes 2005).

THE DIFFERENT KINDS OF FLAT TAX

In principle, a flat tax is a charge levied at a single percentage rate on those transactions liable to the tax. Examples might be:

- a tax on **all** income levied at just one rate, possibly with an exemption for income below an agreed annual limit
- a tax levied on **some parts** of a person's income, again possibly with exemption for an annual set limit
- a tax levied on the purchase (**or consumption**) of goods or services within an economy.

Each of these contains the essential element of a flat tax. This essential element is that **the flat tax charge has fixed proportionality with regard to the tax base.** The resulting taxes are, however, different.

- The first description is of a tax on income, and might be called a single-rate income tax.[4]
- The second is the tax usually described as a flat tax, and broadly describes the Hall and Rabushka proposals, analysed in more detail below. In most cases such taxes are properly considered consumption taxes (Hall and Rabushka 1995: 40), although Hall has described the tax he and Rabushka invented as an 'American VAT' (Hall 2004).
- The third description is of a European-style Value Added Tax system.

It must be stressed that although a flat tax has a single tax rate this does not mean, at least in the first two cases noted above, that the taxpayer has a fixed average tax rate. It means that there is a fixed marginal tax rate on income above an agreed limit. The difference is important and is demonstrated in the following pages.

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[1] <http://www.stanford.edu/~rehall/>.

[2] <http://www.stanford.edu/~rabushka/>.

[3] <http://en.wikipedia.org/wiki/Steve_Forbes> and <http://www.chooseflattax.com/about.asp>.

[4] The author thinks this term helpful, and uses it to differentiate income tax systems having just one tax rate from income tax systems that are otherwise similar but have multiple tax rates in use, as the UK does. The term is not, however, in widespread use.

Table 1.1: Comparison of marginal and average tax rates under flat tax

Earnings	Tax due on first £10,000	Tax due on rest of income	Total tax due	Marginal tax rate on income	Average tax rate on all income
£15,000	£0	£1,000	£1,000	20%	6.6%
£30,000	£0	£4,000	£4,000	20%	13.3%
£60,000	£0	£10,000	£10,000	20%	16.6%
£100,000	£0	£18,000	£18,000	20%	18%

Table 1.2: Comparison of the impact of marginal and average tax rates on progressive tax rates

Earnings	Tax due on first £10,000	Tax due on income up to £50,000	Tax due on rest of income	Total tax due	Marginal tax rate on income	Average tax rate on all income
£15,000	£0	£1,000	£0	£1,000	20%	6.6%
£30,000	£0	£4,000	£0	£4,000	20%	13.3%
£60,000	£0	£8,000	£4,000	£12,000	40%	20%
£100,000	£0	£8,000	£20,000	£28,000	40%	28%

Assume that in a tax system each individual has an annual exempt income level of £10,000, the flat tax rate is 20% and there are four individuals with earnings of £15,000, £30,000, £60,000 and £100,000 respectively. Their marginal and average tax rates will be as shown in Table 1.2.

It will be noted that the effective average tax rate of a person on £30,000 is double of that of a person on £15,000 in this example, whereas the increase in tax rate between an income of £60,000 and one of £100,000 is small. This is a feature of flat taxes. It means that they are progressive at lower rates of tax, but become close to proportional once the impact of the exempt amount becomes small in relation to total income.

If a higher rate of tax, at say 40%, were introduced for income above £50,000 then the results would be as in Table 1.2. The higher rate of tax has no impact on the two people with income below the limits at which it applies. The effect of the higher rate of tax is:

- to increase the average tax rates of those on higher earnings
- to maintain a progression in the average tax rate
- to prevent there being a fixed marginal tax rate, which is the key identifying element of a flat tax.

Much of the debate about flat taxes on income is about whether progression in average tax rates is desirable, but it should be noted that in neither example does a person pay the top headline rate of tax, whether it be 20% or 40%.

The Hall and Rabushka / Forbes Flat Tax

Hall and Rabushka's proposal (1995) for a flat tax applies to both individuals and companies. The details do, of course, differ between the two. The key characteristics, almost all of which coincide with the proposals made by Forbes (2005), are as follows.

1. A single rate of tax for both individuals and companies.
   Forbes suggests a rate of 17%, compared with Hall and Rabushka's 19%. No doubt the difference reflects general downward trends in taxation rates in the intervening years.[5] Teather (2005) suggests a rate of 22% for the UK while Allister Heath (2006) suggests 28% for all but pensioners, but with the rate to include national insurance contributions.

2. Significant exemptions for adults and children.
   Forbes suggests an allowance for each adult that is 66% higher than that available under the US tax code in 2005, with an additional allowance for each child. Under the UK tax system, tax allowances are no longer given for dependent children and married people are not taxed as a family unit. Teather (2005) suggests as an alternative a standard tax-free allowance for each individual of £12,000 per annum, a substantial increase from the (2006/07) £5,035 basic personal allowance.[6] Heath (2006) suggests an individual allowance of £9,000.

3. Changing the basis of taxation.
   The main characteristics of a flat tax when compared with the current UK tax system is shown in Table 1.3 on page 12.

[5] See, for example, KPMG's survey of international tax rates at <http://www.kpmg.co.uk/pubs/taxrates_04.pdf>.

[6] Note: UK tax rates and allowances used in this report are unless otherwise specified those for 2006/07 and are all based on data available from the website of HM Revenue & Customs <http://www.hmrc.gov.uk>.

Table 1.3: Comparison of flat tax with current UK tax system

Description of income, expense or basis of calculation	Treatment under Hall and Rabushka's / Forbes' flat tax	Current treatment under UK taxation law (2006/07)
INCOME		
Wages from within UK	✓	✓
Wages from outside the UK	×	✓(if the recipient is resident and in some other cases)
Share incentive schemes	✓	✓
Compensation for industrial injuries	✓	×
Reimbursement of expense claims	×	×
Benefits in kind for employee	×	✓
Benefits in kind – charge on employer	✓	×
Savings income of all sorts	×	✓
Pensions paid for out of employee contributions	×	✓
State benefits if paid from employee contributions	×	×and ✓(depending on type)
Capital gains	×	✓
Distributions from the estates of deceased persons and some other gifts	×	✓
The income of charities	×	×
RELIEFS		
Relief for interest paid by business	×	✓
Relief for pension contributions	×	✓
Relief for gifts to charities	×	✓
Relief for capital expenditure	✓(in full when spent)	✓(in most cases but over time)
Relief for investment incentives e.g. venture capital trusts	×	✓
Relief given on all cash expenses without adjustment for stock, debtors or creditors	✓	×
Travel and entertaining expenses	✓(but limited)	✓(but limited)
Tax deduction required at source from employees	✓	✓

Sources: Hall and Rabushka (1995: 142–145), Forbes (2005) and UK tax legislation 2006/7.

In the Hall and Rabushka system, tax relief is not provided for interest paid by businesses, since interest is not taxable when received by an individual in a flat tax system. The net effect is similar to an arrangement where tax is deducted at source from all payments of interest. This logic works only within national boundaries; it ignores the possibility that investment income can be derived from outside the country in which a person resides and might not have been taxed at source, so that by placing funds outside their country of residence a person might escape any taxation of interest income. The arrangement also increases the cost of borrowing for domestic firms if overseas competitors continue to enjoy tax relief on the interest they pay.

Key features

The key features shown in Table 1.3 opposite may be summarised as:

- one rate of tax for the income of individuals and companies
- no tax on foreign earnings
- no tax on income from savings
- no tax on capital gains
- no tax on inheritances
- no relief for pension contributions or other savings incentives
- no relief for interest paid
- charities not taxable
- no relief for gifts to charities
- business taxed on cash flow, not profits.

As the contrast between ticks and crosses makes clear, this is very different from the existing UK tax system.

According to Alvin Rabushka, when interviewed for this report, this is the most important benefit of a flat tax system. His main claim for flat taxes is that they 'remove the tax code from the economy'.

He added:

The degree to which it will be achieved will depend upon the rate which is selected – at a 10% rate it will achieve a whole lot more than at a 30% rate.

[Flat tax] *removes the tax code from the economy in the sense that no particular activity is favoured over another.*

If the rate is higher then the people will begin to think about avoidance and evasion and if the rate is lower the less they will think about that.

I like flat tax regimes below 20%; I don't like flat tax regimes very much above 20%.

WHAT THE FLAT TAX REPLACES

The flat tax proposed by Hall and Rabushka (1995) and Forbes (2005) would abolish the following taxes:

1. income tax (Forbes 2005: 59)
2. corporation tax (Forbes 2005: 59)
3. capital gains taxes (Hall and Rabushka 1995: 117)
4. inheritance tax (Forbes 2005: 64).

It must, however, be stressed that their proposed flat tax does not eliminate any other tax, so the following taxes would remain:

1. national insurance (Forbes 2005: 60)
2. sales taxes such as VAT and excise duties[7]
3. local authority taxes (Forbes 2005: 60).

That said, this is still a significant proposal for change, not least because it would leave just one tax in the UK assessed on income (national insurance) with all others being charged on consumption.

SUMMARISING THE DIFFERENCES

The essential difference between the Hall and Rabushka flat tax and the current UK income and corporation tax systems is that flat taxes are a tax on consumption whereas the UK's income and corporation taxes are taxes on income.

As Hall and Rabushka say, 'a consumption tax is a tax on spending rather than income' (1995: 40). The UK's VAT is a consumption tax because it is charged on purchases by end consumers, but this is not of the sort of consumption tax envisaged by Hall and Rabushka.

[7] This is deduced from the fact that Forbes (2005) says that all local and state taxes survive and in the US this is the level at which these taxes are charged. In Forbes (2005: 101) the use of a VAT by Slovakia is endorsed. The US does not have a VAT and as a result the question of its replacement does not arise in a US context.

The difference is substantially in the method of tax collection. For many people, the concept of VAT being collected by direct tax assessment may be hard to comprehend, but Hall and Rabushka (1995: 55) are quite clear about this point. They say '[h]ere is the logic of our system, stripped to the basics: we want to tax consumption'.

The Congressional Research Service of the Library of Congress in the US say they do this by creating a tax with two parts (Congress 2005): 'a wage tax and a cash-flow tax on businesses. (A wage tax is a tax only on salaries and wages; a cash-flow tax is generally a tax on gross receipts minus all outlays.)'

Their report goes on to say, somewhat more technically: 'It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level'.

Another way of looking at this is to recognise that all a person can do with their income is either to spend it on consumption or to save it. Since income from savings is not taxed in the Hall and Rabushka model, and putting cash into savings is also not taxed, then it must follow that savings as a whole are not taxed in this system. Hence the only thing that must be taxed in a Hall and Rabushka flat tax is consumption. The logic may be convoluted, but the economic reality is as Hall and Rabushka say; their flat tax is a charge on consumption, and not income.

This difference is important for two reasons. First, as will be discussed in more detail below, no country has actually adopted Hall and Rabushka's flat tax because none has opted to tax only consumption; all have continued to tax income. This is likely to be because all the countries that have so far adopted flat taxes do already have value added taxes, which are a tax on consumption. If they adopted the Hall and Rabushka flat tax they would in effect tax this source twice.

Secondly, tax systems are most effective at tackling tax avoidance and evasion when there are the fewest possible boundaries between taxes. Hall and Rabushka (1995: 14) suggest their flat tax eliminates such possibilities for avoidance, and the elimination of allowances and reliefs that they propose clearly assists this objective, but their flat tax does open other opportunities for tax planning, particularly the following.

- If income can be shifted offshore in their system it becomes non-taxable. This is often a relatively easy thing to do. For example, a person in a flat tax state that used the Hall and Rabushka scheme could supply their personal services from an offshore company they owned, located in a country where no tax on profit was charged (as is commonly the case in offshore financial centres). If all the owner's income from that company were taken as dividends then, because the income was from abroad and because it had been re-categorised as investment income (rather than income from the supply of labour), no tax would be due and the person supplying the services would escape all tax charges on this source of income.

- If income can be recategorised as gains, for example by the sale of future rights to earnings from a royalty stream, then a tax charge could be avoided.

In addition, and as will be discussed later (see Chapter 2), because investment income and capital gains tend to be earned by the most affluent, the exempting of these sources of income from tax means that the argument that a flat tax is progressive because all income above a threshold is charged to a constant rate of tax does not hold; the argument applies only to earnings from employment. This affects the assessment of the effective rates of tax charged.

THE BENEFITS OF A FLAT TAX

Having identified what a flat tax is, we now look at the benefits claimed for it. The following is a summary of the claims made for a flat tax by Forbes (2005) and Hall and Rabushka (1995).

- **Flat tax will simplify life by**
  - simplifying the tax code
  - reducing the burdens on individuals who have to file tax returns
  - simplifying business administration
  - cutting the number of state employees who administer tax
  - reducing the number of taxpayers.

- **Flat tax will enhance the credibility of the tax system by**
  - reducing the tax rate
  - reducing the incentives for tax evasion
  - cutting or eliminating tax avoidance
  - closing all loopholes used for tax abuse
  - increasing the fairness of the tax system.

- **Flat tax will boost the economy by**
  - stimulating the economy
  - reducing inflationary pressure
  - reducing interest rates
  - encouraging saving
  - stimulating investment
  - encouraging international competition
  - improving corporate transparency.

- **Flat tax will increase social well-being by**
  - providing increased incentives to work
  - protecting wealth
  - supporting the family
  - enhancing the status of government.

Grecu (2004) makes a different case for the introduction of a flat tax in the UK. He argues that 'countries all over the world have understood that in order to be competitive in the global economy, they have to make their economic environments as friendly as possible to international businesses'.

He suggests that flat tax systems are the logical response to the demand for an environment that suits international business and that the ten main benefits of a flat tax system would be:

1. elimination of double taxation on savings and investments
2. increase in government revenue
3. considerable reduction in the time and cost of completing tax forms
4. the end of special interest lobbying, which is responsible for the growing complexity of the tax regime
5. exemption of the poor from paying any tax by means of a generous tax-free allowance
6. more control by individuals over their money and reduction of government infringements on privacy
7. reduction of interest rates because interest would be tax-free
8. reduction of tax evasion by lowering the benefit from avoiding taxes
9. the British fiscal system would be more attractive to foreign investment
10. simplicity, economic efficiency, and fairness.

2. Flat tax and the US

WHY THE US TAX SYSTEM CREATES A DEMAND FOR CHANGE

Hall and Rabushka's flat tax was designed for use in the US. The US tax system is in some ways very different from that of the UK, as the examples below show.

1. The US does not have a national sales tax.[8] The UK has had a value added tax (VAT) since 1973.

2. The US charges income tax on both individuals and corporations at a federal level as well as, in most cases, at state level. The UK charges income and corporation taxes only at the national level.

3. The US tax code depends heavily upon filing of individual tax returns and there is a limited culture of withholding tax at source: 131 million individual tax returns and over 6 million corporate tax returns were filed in the US in 2004.[9] That is, 44% of the total population filed a tax return.[10] In contrast, 9.8 million tax returns were issued in the UK in 2005,[11] covering 16% of the UK population.[12] In Estonia 84% of taxpayers submit a tax return.[13] Many UK persons in paid employment will never complete a tax return as their earnings from employment are taxed at source, as is their investment income. In addition, many of the reliefs to which they are entitled, eg on pension contributions and charitable donations, are paid directly to the recipient organisation.

4. The US tax code is significantly more complicated than the UK tax code. A US citizen can, for example, obtain tax relief on their tax return if they buy certain forms of hybrid fuel cars (Forbes 2005: 11). The relief is intended to promote a clean environment but is indicative of an enormous range of reliefs available to individual US tax payers that are unimaginable to UK tax payers.

5. So complex is the US tax system that at least 70% of US taxpayers elect not to claim all the deductions and reliefs to which they might be entitled and do, instead, claim standard deductions.[14] This is not an option in the UK tax system because it is one that is not needed.

6. Because the US tax system creates so many reliefs and deductions, a person's tax rate can fall to what is considered an unacceptably low level by the US Tax Code. At that point another tax is used and the taxpayer's tax liability is calculated under the rules of the Alternative Minimum Tax.[15] This cancels the reliefs that would otherwise be available. Some have suggested that this is, in fact, a form of flat tax at either 26% or 28% (depending upon circumstances),[16] but others contest this.

[8] The US does have local sales taxes using a wide variety of rates and methods of calculation varying from state to state and county to county, but no national tax. See the web site of the American Institute of Certified Public Accountants <http://www.aicpa.org/yellow/yptstax.htm>.

[9] Document 6292 downloaded from <http://www.irs.gov/taxstats/article/0,,id=97308,00.html> on 2/1/06.

[10] Population data from <http://www.cia.gov/cia/publications/factbook/geos/us.html> on 2/1/06.

[11] <http://www.gnn.gov.uk/content/detail.asp?ReleaseID=182746&NewsAreaID=2&NavigatedFromSearch=True>, accessed 2/1/06.

[12] Population data from the Office of National Statistics <http://www.statistics.gov.uk/CCI/nugget.asp?ID=6>, accessed 2/1/06.

[13] Information supplied by Ivo Vanasaun, Head of Direct Taxes Division, Estonian Ministry of Finance, during an interview undertaken for the purposes of this report 16 February 2006.

[14] Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing: United States General Accounting Office, April 12, 2001 downloaded from <http://www.gao.gov/cgi-bin/getrpt?GAO-01-529>, accessed January 2006.

[15] See the website of the US Internal Revenue Service <http://www.irs.gov/newsroom/article/0,,id=107843,00.html>.

Because of these characteristics of the US tax system, US taxpayers may be:

- more aware of their actual levels of income than are the many UK taxpayers who do not have to prepare a tax return
- more aware of the tax that they pay, for the same reason
- generally bear a greater administrative burden with regard to tax than is usual in the UK, this being particularly true of employees.

Anecdotal evidence from a wide range of US websites suggests that this is the case.[17]

It is curious that, despite his belief that flat taxes reduce the administrative burdens on individuals, Alvin Rabushka thinks that everyone should be compelled to complete a tax return, something that is alien to the UK tax environment. When interviewed for this report he said:

I would have everyone fill in a tax return because a) I want every citizen to do individual accounting each year with his government [and] *b) I believe that if everybody each year had to fill out their own individual tax return they'd be a little bit more demanding politically about how their money is spent.*

In the case of the income tax for those who don't have to file because it is done by the business for them they're not really very conscious of value for money in public services but I'm willing to offer a compromise to this. I would be happy with a slight modification in which all of those British nationals who don't have to file a return because pay as you go covers it: that is that at the end of the year the company sends out a form which shows how much tax was paid in duplicate and you have to sign the form and return one copy and keep the other, that would be the equivalent of having to file a tax return so that you're told at the end of each year, by golly this is what you paid and I think that anything that brings home to the average taxpayer each year the absolute amount paid in tax and you have to stare it in the face, I think that's a more effective political vehicle for raising questions about the efficiency and value of public expenditure.

He made it clear that in this way he wants a flat tax in the UK to help to create the awareness of tax that exists in the US system.

[16] For example, see <http://www.newsmax.com/archives/articles/2005/12/25/210345.shtml>.

[17] See, for example, the list of civil society groups concerned with tax at <http://www.taxsites.com/policy.html>. In the UK this concern tends to be limited to professional institutes and trade bodies, eg ACCA and the Forum of Private Business.

WHAT THE FLAT TAX LOBBY SAY ABOUT THE US TAX SYSTEM

Closely reflecting the opinions of Hall and Rabushka (1995), Forbes (2005) makes the following comments on the US tax system.

1. Americans pay too much tax (2005: 4). In making this claim Forbes does, however, cover a broad range of taxes such as federal income taxes, state income taxes, social security charges and sales taxes.

2. The tax code is too complex (2005: 5). Forbes notes that it contains more than 9 million words and compares this with the Bible's 773,000 words.

3. Tax breeds corruption (2005: 8). He criticises much tax avoidance and the lobbying that creates these opportunities. He describes this as 'useless economic activity'. He also suggests that the complex tax code encourages tax evasion.

4. The tax code is unfair (2005: 10). Many deductions available under the US tax code are claimed only by the affluent and it tends to be middle-income earners who are caught by the Alternative Minimum Tax. He suggests as a result that middle-income earners are suffering under the existing system.

5. Tax discourages economic growth (2005: 11) because, he argues, 'taxes are the price the government charges us to work'. He suggests that if the price of work were reduced more work would be done. He also suggests that there would be more saving.

6. The tax code undermines trust in the government (2005: 15). Because the tax code allows people on the same income to pay different amounts of tax depending upon their circumstances and the choices they make about their expenditure, he argues that people are not confident that the government is treating them equally and that this undermines the social contract.

OTHER FLAT TAX PROPOSALS

It should be noted that the flat tax promoted by Hall and Rabushka is not the only proposal for reform of the US federal tax code. Other options that have been proposed (Congress 2005) include the following.

1. A European-style VAT; the US has no such tax.

2. A retail sales tax. This tax differs from a VAT by being charged only to consumers. The difficulty is that it is very hard to identify who consumers are in many cases.

3. Consumed income tax. This is, in effect, an income tax except that any transfers to designated savings accounts (which may well share many of the characteristics of a personal pension fund) would be considered deductions from income.

Although flat taxes are the most talked about of the proposals before Congress (largely because tax systems bearing this title are in use in a number of East European countries), Steve Forbes thinks that a national retail sales tax is the most likely challenger to his flat tax proposal. He dedicates a whole chapter of his book to suggesting why it would not work as a replacement for the federal income tax (Forbes 2005: Chapter 5). It is claimed that 600,000 Americans have joined organisations that support a retail sales tax.[18] The proposals for such a tax before Congress are said to have the strongest legislative support of any proposal for tax reform before the House.[19] Because VAT is universal in Europe there is no equivalent political move in either the UK or continental Europe.

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[18] <http://fairtaxreform.blogspot.com/2005/04/geter-done-economists-nationwide.html>, accessed 4 January 2006.

[19] Ibid.

3. Countries that have flat tax systems

Table 3.1shows the countries which are considered to have flat taxes (HM Treasury 2005a). In each case their year of introduction and their current personal income tax, corporation tax and VAT rates are shown in Table 3.1.

Several issues can be identified from Table 3.1.

- Three countries have more than one income tax rate, even if in each case one is used predominantly. For example, Russia charges 9% on dividend income as opposed to 13% for all other income.
- Three countries also have more than one corporation tax rate, although in Estonia this is because the tax rate depends on whether the profit is distributed or not. In that country the effective corporation tax rate is 24% when distributions are made, but 0% on retained profit.
- Reliable data are hard to secure in some cases, eg in Romania. Many of the tax systems of countries that have recently adopted flat taxes are subject to frequent change at the time of writing.

Some trends are also apparent.

- Early adopters generally have higher tax rates than more recent adopters.
- Early adopters tend to be the countries with more variations in rates.
- Early adopters have income tax rates higher than corporation tax rates. This trend has been reversed among recent adopters, with Slovakia (the only country to have a consistent income tax, corporation tax and VAT rate) apparently the pivotal country in this case.

Table 3.1: Countries with flat tax systems

Country	Year of adoption	Current personal income tax rate(s)	Current corporation tax rate(s)	Current VAT rate(s)
Estonia	1994	24%	0% and 24%	5%–18%
Lithuania	1994	10%–35% (but mainly 33%)	10%–15%	5%–18%
Latvia	1995	25%	15%	5%–18%
Russia	2001	9%–13%	10%–24%	0%–18%
Serbia	2003	14%–24%	10%	8%–18%
Slovakia	2004	19%	19%	19%
Ukraine	2004	13%	25%	20%
Georgia	2005	12%	20%	18%
Romania	2005	16%	16%	Not known

Source data on tax rates: see footnote 21.

In all cases where a flat tax has been adopted, previous, higher rates of tax were lowered. For example, the flat tax in Romania replaced personal progressive tax brackets ranging from 18% to 40% and a corporate tax rate of 25% (Ernst & Young 2005). It should be noted, however, that in almost every case one of the principle motivations for change was the need to recover tax where the previous system had failed to do so. For example, the CIA *Factbook* says that Georgia 'suffered from a chronic failure to collect tax revenues, however, the new government is making progress in reforming the tax code, enforcing taxes, and cracking down on corruption' (CIA 2006). For the same reason, Ivo Vanasaun, Head of Direct Taxes Policy Department in the Ministry of Finance of Estonia, admitted in February 2006 that Estonia cannot compare its achievement in using a flat tax with its previous economic record because those records are too unreliable.[20] This is a theme returned to later in this report (see Chapter 6, 'The impact on the public purse').

ARE THESE FLAT TAXES?

The countries shown in Table 3.1 are now assumed to have flat taxes, even though some have multiple tax rates for either income or corporation taxes. This is because they do predominantly operate single rate tax systems. As already noted, however, the use of a single tax rate is only one indication of the existence of a flat tax system on the Hall and Rabushka model. The others are:

- one rate of tax for the income of individuals and companies
- no tax on foreign earnings
- no tax on income from savings, including pensions
- charities are not taxable
- no tax on capital gains
- no tax on inheritances
- no relief for pension contributions or other savings
- no relief for interest paid
- no relief for gifts to charities
- no other allowances and reliefs
- business taxed on cash flow, not profits.

Table 3.1 shows that all countries bar Slovakia and Georgia fail the first test. It is important to review whether the others also apply. Table 3.2 (see p. 22) explores these and other related issues.[21]

[20] Speaking at the International Academic Forum on Flat Tax Rate, Bled, Slovenia, 3 February 2006.

[21] Extensive research was required to produce this table. Sources include country taxation guides published by PricewaterhouseCoopers and KPMG (in the main), Deloittes and Ernst & Young. Additional information came from worldwide-tax.com and the American Chamber of Commerce in Georgia. Wherever possible multiple sources have been used to ensure the latest data are reported. Despite this, in some cases information could not be found. In no case should the information in this table be used as the basis of an investment decision. It is provided for illustrative purposes only. All data were accessed in January and February 2006.

Table 3.2: Taxable income in flat-tax countries

Country	Are savings taxed?	Are pensions taxed?	Are overseas earnings taxed?	Are capital gains taxed?	Is there an inheritance tax?	Do pension contributions attract tax relief?	Are charitable contributions tax deductible?	Is there relief for mortgage interest paid?	Are there other tax deductions and reliefs?
Estonia	✓	Mainly	✓	Mainly	×	✓	✓	✓	×
Lithuania	✓	Some	✓	✓	✓	✓	✓	×	✓
Latvia	✓	×	✓	✓	×	✓	✓	×	✓
Russia	✓	✓	✓	✓	✓	×	✓	✓	✓
Serbia	✓	✓	✓	✓	×	×	✓	×	✓
Slovakia	✓	✓	✓	✓	×	✓	×	×	×
Ukraine	✓	✓	✓	✓	✓	✓	✓	✓	✓
Georgia	✓	×	n/k	✓	n/k	n/k	✓	n/k	n/k
Romania	×	✓	✓	n/k	×	n/k	n/k	n/k	n/k

Notes

✓= yes; ×= no; n/k = not known.

Where a comment is made this is a value judgement based on available information.

Source: see footnote 21, p. 21.

Other tax deductions include relief for the cost of commuting in three cases and relief for the cost of education in all five cases noted. Other reliefs, eg for trade union subscriptions and professional fees also appear to be available in some instances.

In addition, testing was done to see whether business taxation was assessed on a cash flow basis and whether 100% capital allowances were provided. There was no case where a cash flow basis was used and likewise no case where 100% first year allowance for capital expenditure was allowed for anything but the very smallest of companies.

If pure flat taxes were in operation the answer to all the questions in Table 3.2 should have been 'no'. That means (taking the additional points on the basis of tax preparation and the treatment of capital expenditure into consideration) that there should have been a total of 99 'no' answers. Data could not be found for ten questions. In the three cases where a comment has been made the answer is taken to be 'yes' since in every case at least some of the income described is taxed. On that basis, on the remaining 89 tests only 16 'no' answers can be given (18%). This leaves 73 positive answers (82%). Slovakia has the purest flat tax, with four negative answers. The Ukraine had no negative answers.

When interviewed, Alvin Rabushka said of these systems:

I would say that all of these countries are flat tax regimes in the sense that there's only one marginal rate of tax above the threshold. None of them meet 100% of the criterion of the HR framework … but in every case they are better than what they replaced … and are a whole lot better than most of everything in the rest of the world.

It is, however, interesting to note that he was not aware of all their characteristics. He said:

You know almost every country in the world has a territorial tax system. Very few have a global tax system and this is true despite the fact that you have relatively easy movement of capital and open borders. By territorial I mean income earned in the country is taxable, income earned abroad is not.

When the evidence noted above that all the flat tax systems use what he calls a global tax system was presented to him he was surprised and sought reassurance that this was indeed the case.

THE EVIDENCE FOR SIMPLIFICATION

Alvin Rabushka argues that simplification is the most important component of the flat tax. He said, when interviewed, 'the whole purpose of a flat tax is really to simplify the system and produce a more efficient economy'. We need to consider the value business owners put on simplicity and then whether simplification has actually happened in the countries in Table 3.2.

Those in business who favour flat taxes appear to do so because they wish for a simplification of the tax system. The Tenon Group (a stock-exchange-listed UK firm of accountants) published the results of a survey of opinion on flat taxes among UK businesses in December 2005. Key findings (Tenon Group 2005) were as follows.

- 78% of those surveyed thought the UK tax system too complicated.
- 73% were in favour of a flat tax scheme.
- Those in favour of flat taxes thought they were better because they would:
  - save them time (98%)
  - be simpler (97%)
  - save them money (78%).

- Those who disapproved of a flat tax system gave the following reasons:

  – they were happy with the existing system (4%)
  – flat tax would be more time consuming (13%)
  – flat tax would be more difficult to administer (24%)
  – flat tax would cost them more (20%).

Those who prepared the report added the following observations.

- The bigger the business the less likely it was to be in favour of flat taxes.

- A flat rate tax was particularly popular with retail, leisure and utility companies, of whom 84% were in favour of the change.

- There was a strong feeling that a lack of understanding about how a flat rate tax scheme would operate meant it was being positioned erroneously as a panacea.

- Some questioned how long the new system would remain 'simple' and pointed out that in reality companies often benefit from the current system's complexities in the form of grants, exemptions and allowances for small and medium-sized businesses.

Despite the doubts expressed by Tenon, it is clear that those they surveyed have a strong desire for simplicity. In that context, the review of rates and allowances in Table 3.2 was extended to note whether complexity was removed within the flat tax systems of Estonia, Latvia, Lithuania, Russia and Slovakia, which are the most developed of the flat tax nations and are therefore likely to provide the best evidence of how the system might work in practice.

[22] Reproduced from pages 62 and 63 of Investment in the Baltic States: A Comparative Guide (KPMG 2005).

Evidence on complexity

The potential complexity of business taxation in a flat tax state is shown by the following lists of partly disallowable and wholly disallowable expenses that might be incurred by a business in Lithuania.[22]

Partly allowed expenses, which may be tax-deductible subject to certain requirements, include the following:

- *depreciation and amortisation of fixed assets;*
- *maintenance, repair and reconstruction of fixed assets (except for cases when such maintenance, repair or reconstruction prolongs period of duty of fixed assets);*
- *business trips;*
- *advertising and entertainment;*
- *ordinary loss of inventories;*
- *taxes;*
- *bad debts;*
- *payments to the benefit of employees;*
- *provisions of credit institutions and insurance companies;*
- *granted support;*
- *membership fees;*
- *tax losses.*

The main types of non-deductible expenses are as follows:

- *penalties and default interest;*
- *interest and other payments related to the obligations of related parties;*
- *expenses paid to the related parties due to damaged or wrongly produced production exceeding the earned income;*
- *charity and support (except for the deductible part of support);*
- *payments to foreign entities, which are not taxed by withholding tax;*
- *compensations for damages;*
- *dividends and other appropriations;*
- *expenses of purchased goods (services) from tax haven entities, if these goods (services) are not paid for after more than 18 months;*

- *payments to tax haven entities if a Lithuanian entity does not prove that these payments are related to ordinary activities of tax haven entities.*

The quotation is lengthy, but the point is important. This list suggests that there is a complex system in operation. What is clear from the survey undertaken to prepare Table 3.2 is that broadly similar lists could be produced for the other flat tax states that were reviewed.

There are other issues and complexities within the Lithuanian tax system. For example, companies in Lithuania must use 'official' rates of straight-line depreciation if that charge is to be allowed for tax. There are 12 categories of asset, varying from ships and trains to goodwill and capitalised interest. Five groups have a 33.3% allowed rate. The remaining groups use asset lives that vary between 4 and 20 years. It is immediately apparent that such a large range of differing asset categories and tax relief rates will produce problems in allocating assets to appropriate categories and in calculating available tax reliefs.

Others

Lithuania is far from alone in having such complications. For example, Russia has ten asset groups for tax depreciation purposes while Latvia has seven and Slovakia has four groupings covering periods from 4 to 20 years.[23] Estonia appears more liberal, allowing accounting depreciation charges, but this is within the context of its quite different system where corporate profits are taxed only on distributions made.[24]

The only evidence of simplicity comes from those countries that allow some reliefs for smaller enterprises. For example, Russia allows the cash basis to be used by some very small businesses.[25] Slovakia goes further: taxpayers who are not VAT-payers can choose to claim deductions equal to a fixed percentage of income without a need to substantiate the costs with documentation. The fixed percentage of expenses is 25 to 60 percent of income, depending on the type of business.[26] With these notable and interesting exceptions, evidence of simplicity was hard to find.

NATIONAL INSURANCE

The above considerations relate to business taxation and VAT. A further tax to consider is the charge for social security contributions, comparable to national insurance in the UK. Rates for this are shown in Table 3.3 (see p. 26).

These rates contrast quite significantly with those in the UK, where the equivalent employee rate is 11.0% and that for employers is 12.8%, giving a combined total of 23.8% of gross wage cost. This contrast is reflected in the respective importance of social security contributions in the total taxation revenues of the flat tax countries. For example, the contributions to the total tax take of personal income tax, corporation tax, VAT and social security contributions in 2003 for Slovakia, Estonia and the UK are as shown in Table 3.4 (see p. 26).[27]

It is apparent that Slovakia, which generates just 20.2% of its total taxation revenue from direct taxes, can take many more risks with regard to that source of income than can the UK with 36.4% coming from the same sources. Any flat tax proposal for the UK has to take this into account.

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[23] Information from <http://www.wordwide-tax.com>.

[24] <http://www.investinestonia.com/index.php?option=display page&Itemid=73&op=page&SubMenu=>, accessed February 2006.

[25] KPMG (2005), Russia Tax Overview.

[26] PricewaterhouseCoopers 'Information Guide to Slovakia', 2004, p. 90.

[27] Data from Eurostat 'Structures of the taxation systems in the European Union: Data 1995–2003', 2005 available from <http://epp.eurostat.cec.eu.int/portal/page?_pageid= 1073,46587259&_dad=portal&_schema=PORTAL& p_product_code=KS-DU-05-001>.

Table 3.3: Social security contributions

Country	Employee's contribution rate	Employer's contribution rate	Combined contribution rate
Estonia	0%	33.0%	33.0%
Lithuania	3.0%	31.0%	34.0%
Latvia	9.0%	24.09%	33.09%
Russia	0%	40.0%*	40.0%*
Serbia	17.9%	17.9%	35.8%
Slovakia	13.4%	35.2%	48.6%
Ukraine	0%	38.0%	38.0%
Georgia	0%	20.0%	20.0%
Romania	n/k	n/k	n/k

Source: see footnote 21, p. 21.
Notes: n/k = not known * = approximate average, a range of rates are in use.

Table 3.4: Contribution to total tax take

Country	Personal income tax	Corporation tax	VAT	Social security
Slovakia	10.9%	9.3%	22.3%	40.2%
Estonia	19.4%	9.3%	17.7%	35.8%
UK	28.8%	7.6%	19.8%	18.0%

Source: Eurostat (2005), 'Structures of the taxation systems in the European Union: Data 1995–2003', available from <http://epp.eurostat.cec.eu.int/portal/page?_pageid=1073,46587259&_dad=portal&_schema=PORTAL&p_product_code=KS-DU-05-001>.

WEIGHING UP THE EVIDENCE

The evidence from these data suggests that within the countries surveyed there are no flat taxes in operation of the sort Hall and Rabushka describe.

- Savings income is taxed in all states bar Romania, where the situation is not clear.
- Corporation tax and personal income tax rates are coordinated in only two states.
- Overseas earnings are taxed in all states where data can be ascertained.
- Capital gains are taxed in most states.
- A considerable range of deductions and reliefs remain available within these countries, with many of these deductions being more complex than those currently available in the UK.
- Business is not taxed on a cash flow basis in any country with a flat tax.
- A wide range of rules for the deduction of business expenses are in operation. These rules for business expenses do not appear to correspond to the simple precepts laid down in Hall and Rabushka (1995).
- In no case are 100% capital allowances available on expenditure on capital equipment; instead, rules of some complexity apparently operate.
- social security payments of business in flat tax countries are much higher than in the UK.

In summary, and within the context of the flat tax proposed by Hall and Rabushka:

- no country in Eastern Europe is operating a consumption tax of the sort Hall and Rabushka call a flat tax
- the countries in question do instead appear to be operating tax systems that either are, or are close to, single rate income tax systems.

This is a significant conclusion. It means that the shift towards 'flat taxes' seen in Eastern Europe has not been one towards simplicity, as the flat tax model implies, but is instead a shift towards single rates of income tax.

It should be noted that this situation is also reflected in many of the other states and territories that proponents of flat taxes claim operate them (Teather 2005). For example, Jersey and Guernsey, which have both had 20% tax rates for considerable periods of time (66 years in the case of Jersey), have also offered considerable exemptions and reliefs. So prevalent have these reliefs been that Jersey is now planning reform of its tax laws and one slogan it is using in connection with this is '20% means 20%'.[28]

In this case reasonable questions arise as to whether 'flat taxes' do offer simplicity or whether any benefits they give rise to result purely from lower tax rates. David Martin, writing for the Centre for Policy Studies (2005), argues: 'The question of whether simplifying tax and reducing tax rates are connected, or whether they are independent objectives, needs to be properly analysed, as this impacts on the discussion of possible ways forward'.

It is to these issues that this report turns next.

[28] See <http://www.gov.je/TreasuryResources/IncomeTax/Bulletin+Board/roposals+for+Introducing+20+Means+20/default.htm>, accessed 7 February 2006.

4. Testing the benefits of flat taxes

If flat tax theory is right, the two consequences that follow from the introduction of flat taxes are:

1. tax rates fall

2. all aspects of tax administration are simplified.

Each needs to be considered in turn, building upon the evidence already found.

TAX RATES

It has already been noted that tax rates have fallen in the states that have introduced 'flat taxes'. All moved from multiple tax rates to what are (with minor exceptions in some cases) single-rate tax systems, albeit with different rates for individuals and corporations in most countries.

SIMPLIFICATION OF TAX ADMINISTRATION

The main benefits claimed for single taxation rates are:

- it is easier to calculate tax due – Steve Forbes suggests that this results in 'postcard' tax returns (Forbes 2005: 73)
- it is easier to understand tax due (Teather 2005)
- it is easier to collect tax due (Hall and Rabushka 1995: 12–19)
- low tax rates encourage effort and entrepreneurship (Teather 2005)
- tax avoidance and evasion are discouraged (Hall and Rabushka 1995: 12–19)
- total taxation revenues increase (Grecu 2004).

These claims will be tested in turn.

Ease of calculation

This claim appears incontrovertible. If an agreed figure for income has to be multiplied by only one tax rate instead of being split into parts to be multiplied by a variety of rates, the calculation of tax due must be simpler than it is in a multiple tax rate system. Steve Forbes has heavily promoted this simplicity by suggesting that using his flat tax system would allow a 'a postcard [tax return] to abolish the IRS',[29] which is the subtitle of his book (Forbes 2005). This idea originated in Hall and Rabushka (1995: 52ff).

This advantage might not, however, be as substantial as is claimed. It is normally the case that computing a tax liability upon a known income is a much smaller task than deciding what the income should be taxed, and as has been noted in chapter 3, the accounting rules for calculating income and the rules for calculating allowances and reliefs within countries with flat taxes appear at least as complex as those in the UK in most cases. In that case the benefit obtained from ease of calculation appears of little overall consequence in itself.

Ease of understanding tax due

There is no doubt that tax is confusing to many people. This sentiment appears implicit in the findings of the Tenon Group (Tenon 2005). It is unlikely that 78% of their respondents would suggest the tax system was too complex if they could understand it.

[29] The IRS is the Internal Revenue Service of the US, the equivalent of HM Revenue & Customs in the UK.

As Table 1.2 (see p. 10) of sample tax rates for a range of individuals shows, there can be no doubt that multiple tax rates complicate the calculation of tax due. Alvin Rabushka goes further with his aim of simplification in this area, saying in interview for this study that corporate and personal tax rates, 'have to be exactly the same rate. It's critical'.

Those who support a flat tax claim that the marginal rate of tax causes complications in understanding tax due, and acts as a disincentive to effort. (Forbes 2005). This does, however, assume that taxpayers:

- know their income
- understand how tax is calculated on that income, including all the tax brackets involved
- know the tax rates that apply to their top rate of income.

Such assumptions depend in turn on assumptions that:

- the tax system is comprehensible, or
- people assume they pay tax at the highest marginal rate.

If the first applies then the argument of those who promote flat taxes is not true. If the second applies it cannot be acceptable to propose a change in taxation because taxpayers have not acquainted themselves with their own situation. It seems, as David Martin suggests for the Centre for Policy Studies (2005):

Two rates for individuals (a basic and a higher rate) and one or two rates for companies would not result in particular complexity. Moving from that possibility to a single low rate would have to be justified on other economic or political grounds, rather than simply the objective of simplicity.

As Dominic Maxwell of the Institute for Public Policy Research also points out, complexity is not created only by tax rates (2006): 'In reality, most of the complexity would remain with the rules designed to prevent tax avoidance and much of what is removed would have to be recreated in the benefits system'.

In a note that strikes a chord with the comments of the Centre for Policy Studies, Maxwell adds: 'Simplicity is an important goal – but not at any price'.

It may be that a flat tax would make it easier for people to understand their own tax liability, but the price of achieving that understanding may be too high. As Mark Nicholson, writing for the Conservative Bow Group in January 2006 (Nicholson 2006) argues: 'It is my view that a direct move to a flat tax system would cause too much upheaval to the tax system and too great a change to the distribution of the burden of taxation to achieve the necessary degree of popular acceptance'.

Ease of collection

This argument is closely related to the claim discussed on p. 36 that under flat tax systems the total tax take can rise. The ease of collection argument assumes that in a simple tax system with low costs of taxpayer compliance and easily calculated liabilities, fewer tax officials can collect more taxes while making fewer mistakes.

The latter point seems pertinent. In February 2006 the House of Commons Public Accounts Committee reported that 'around 30% of completed tax returns contain errors and around £2.8 billion of revenue may be lost through inaccurate returns' (House of Commons Public Accounts Committee 2006).

The evidence to support this claim for flat tax is hard to assess, as is commonplace in anything to do with flat tax when empirical data are sought. Indeed, as the UK Treasury points out (HM Treasury 2005a): 'in all discussions on flat tax structures it must be remembered that the debate is in part so fierce

because so little hard evidence exists to support the pro-flat tax claims. The lack of raw data to support and substantiate proponents' claims is evident'.

There is, however, circumstantial evidence to support the claims. For example, the Government of Romania National Commission of Economic Forecasting has suggested that the introduction of a flat tax has led to 'a reduction of bureaucracy and an increase in the transparency of tax collection'. It is suggested that this has resulted in increased voluntary compliance with the tax code and from recovery of long-outstanding taxes due (Videanu 2006).

These changes are no doubt welcome, but note that that Romania is one of the three recent Eastern European transition economies that have adopted flat taxes against a background of internal chaos, the others being Georgia and Ukraine. According to PricewaterhouseCoopers 'Ukraine is no tax paradise. However there is no arbitrariness on the part of tax authorities, as there was five years ago'.[30] In Romania the IMF said in a press release[31] in 2004 'the authorities are confronting the long-standing issues of tax arrears'.

Against this background of previous substantial non-compliance with tax legislation, any further reduction in tax collection would have been surprising. Additional evidence does, however, suggest that this increase in tax collection may not be just because of the introduction of the new flat tax system. According to KPMG 'On account of the adoption of reduced tax rates, both for juridical persons from 25% to 16%, as well as the adoption of the unique income tax rate of 16% for physical persons, the fiscal authority in Romania pays an increasing attention to the administration and collection measures of the state incomes'.

The flat tax was introduced to Romania on 1 January 2005. Official statistics on Romanian tax collection in 2005 compared with those in 2004 are shown in Figure 4.1 (Videanu 2006).

What is apparent is that although the new system resulted in substantial increases in revenues from some taxes, such as VAT (up 36%) and social security (up 18.7%), income tax revenues fell by 5.3% and taxes on profits increased by less than 1%. The evidence that flat taxes, by themselves, increase tax revenues is hard to find in Romania – rather the evidence suggets that it is good tax collection regimes that result in increased tax revenues.

The same may be true of Russia. A combined study by scholars from the Institute for Fiscal Studies in the UK, the International Monetary Fund and University College London was published in July 2005 (Ivanova et al. 2005). As background to the study the authors noted: 'In 2001, Russia dramatically reduced its higher rates of personal income tax (PIT), establishing a single marginal rate at the low level of 13%. In the following year, real revenue from the PIT increased by about 26%'.

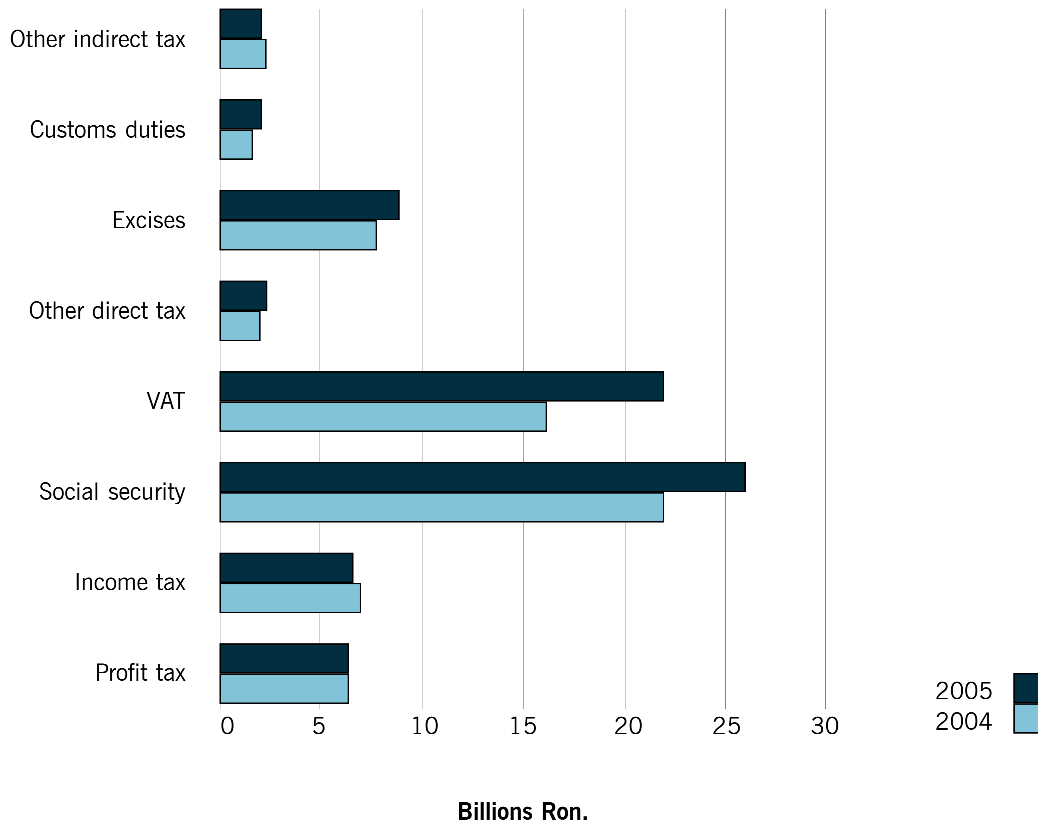
In their research, the authors sought to determine whether the increase in tax revenue was itself a consequence of this reform. They conclude that: 'there is no evidence of a strong supply side effect of the reform. Compliance, however, does appear to have improved quite substantially – by about one third, according to our estimates – though it remains unclear whether this was due to the parametric tax reform or to accompanying changes in enforcement'.

[30] <www.pwcglobal.com/extweb/pwcpublications.nsf/docid/48144A6A0952EFAB80256FAC005280DA>, accessed February 2006

[31] <http://www.imf.org/external/np/sec/pr/2004/pr04137.htm>, accessed February 2006

[32] KPMG Romania 'Tax Audit' June 2005 available from <http://www.kpmg.ro/index.thtml/en/about/news/index.html?cid=52616e646f6d4956f96c94868ca868b888c2e903bc204e5c, accessed February 2006.

Figure 4.1: Total tax revenues in Romania



Source: Videanu (2006).

As a result the authors state 'it is hard to attribute the very strong performance of PIT revenues after the reform to tax reform itself' (Ivanova et al. 2005: 432).

When read in conjunction with the evidence from Romania it appears that enforcement procedures might have the most significant effect in increased tax revenues in both cases. The evidence from Russia suggests that Romania is following a trend because, just as Romania saw substantial increases in its revenue from taxes such as VAT following the introduction of a flat tax, so did Russia in 2001. In that year, while income tax revenues in Russia increased in real terms by about 26%, those from indirect and trade taxes increased by almost the same amount.[33] As Ivanova et al. note, this suggests a common underlying cause. They suggest that the common cause was growth in the Russian economy (Ivanova et al. 2005: 433).

[33] Ibid.

It should, however, be noted that Yegor Gaidar from the Institute for Economies in Transition in Moscow, where the Russian tax reforms were designed, disagreed with the conclusions on revenue collection reached by Ivanova, Keen and Klemm when both he and Michael Keen presented papers at the conference on flat tax held in Bled, Slovenia in February 2006. He is firmly of the opinion that the increase in revenues resulted solely from the flat tax and that no changes in enforcement occurred.

Low tax rates encourage effort and entrepreneurship
Whether this argument is true depends on whether people know that the tax rates that they pay are lower then they were before. In the case of some economies this is obvious. For example, Russia cut its top rate income tax from 30% to 13% when introducing its flat tax reforms (Ivanova et al. 2005). For others this is harder to assess. For example, as the same source notes, the starting rate of tax in Russia fell by just 1.3% when flat taxes were introduced, once social security charges on wages were also taken into account. Such change is likely, all other things being equal, to have less impact on a person than a fall in the tax rate from 30% to 13%.

The study by Ivanova et al. appears to be the only one that has looked at the effect of such tax changes on effort in an empirical way, when directly associated with flat taxes. The main findings of the work are as follows.

- The increase in income revenues following the 2001 reform was mainly the result of developments among individuals who were largely unaffected by it, ie extra was paid by those whose rates were not changed.

- There is no evidence that additional effort was expended, as a result of the changes, by those whose tax rates were cut when the flat tax was introduced, since their gross incomes fell and their hours worked were largely unaffected.

- The only, but potentially important, positive effect detected in the group most affected by the introduction of flat taxes (whose tax rates fell, in other words) was an improvement in compliance. (Ivanova et al. 2005: 431–2)

In addition to the above findings, the authors of the report note the following points.

- Tax revenues from personal income tax increased by 25.2% in real terms between 2000 and 2001.

- This overall rise was due to growth of 35.7% in the group whose tax rates were affected least by the change, while tax payments by those whose tax rates fell the most grew by only 4.7%.

- These changes are compared with what would have happened if there had been no change in the tax system. In that case tax receipts from those most affected by tax rate cuts would have fallen by 11.4%, while those from the group whose rates changed little would have increased their tax paid by 0.8%. Overall, tax receipts would have fallen by 3%. As a result, the authors conclude that the tax increases in the lower part of the income distribution were insufficient to compensate for the tax cuts higher up the distribution.

- In that case the authors conclude that the increase in the tax take is explained by the increase in declared gross incomes. The nature of this increase, however, differs greatly between the two groups. The declared incomes of those on lower earnings, and so least affected by the changes, increased by 27.5%, most of which (23.9%) came from higher income rather than improved tax compliance. In the higher income group, on the other hand, declared incomes increased by 17%, and this was all due to improved compliance, since actual gross incomes for this group in fact fell quite strongly.

- Because the lower-paid group was much larger in number it was their increased incomes and not the improved tax compliance of those with higher earnings that gave rise to the overall improvement in tax revenue.

- If social security contributions are allowed for, then revenues from the high-earning group actually fell, even taking improved compliance into account. In that case, the authors come to the overall conclusion that the reform did not pay for itself (Ivanova et al. 2005: 432). Moreover, the reform did not encourage additional work effort on the part of those who benefited most from the tax changes.

This finding is contrary to that suggested as likely in a US study by Martin Feldstein (1995). He tested the sensitivity of taxable income to changes in tax rates, based on a comparison of the tax returns of the same individual taxpayers before and after the 1986 tax reform in the US. This was not a flat tax reform but it did cut tax rates and did reduce the range of allowances and reliefs available, and it was influenced by the work of Hall and Rabushka. Feldstein's analysis shows a substantial response of taxable income to changes in marginal tax rates. In other words, Feldstein suggests that as tax rates are reduced, work effort increases. Austan Goolsbee, undertook similar research (1999) on tax changes that occurred over a period of six decades, but has concluded that the result in the 1980s was aberrational. He identifies this effect only in the 1980s, and at no other time.

A team from the analysis and research department of the Bank of Slovenia led by its director, Damjan Kozamernik, has tackled this issue in a different way. They have built a general equilibrium model of the Slovenian economy as part of their testing of whether a flat tax would benefit that country (Kozamernik 2006). Their purpose was to assess the conditions where a flat tax might pay for itself in Slovenia. Their conclusions focus heavily on the elasticity of supply of labour, ie whether an increase in the value of reward induces more labour into the market. Their findings suggest:

- a flat tax might demotivate the low paid in Slovenia as they might pay more tax

- if the elasticity of supply of labour is high then a cut in tax rates, such as those a flat tax might supply, might induce more work effort from the higher paid, but most people in Slovenia are not in this group

- if, as the authors imply is likely, the labour market is inelastic then progressive taxes and not flat taxes would probably optimise economic output in Slovenia.

Sinclair Davidson has broadly similar findings in Australia. He concludes (Davidson 2005: 10) that 'self-employed entrepreneurs and workers with control over their working hours do respond to tax changes. It is possible that high rates of tax would induce more leisure (rather than more work) for some individuals'.

There are several instances common to many economies, where wage supply may be inelastic in response to changes in tax rate, including:

- where minimum wage rates are set by statute and not by the market

- where higher-paid people already work to their full capacity and marginal changes in cash reward will not alter this work input

- where the structure of employment contracts, which are often regulated by factors other than tax, reduce the elasticity of supply of labour

- where some people substitute leisure for work in response to higher cash rewards.

As Kozamernik (2006) notes, the biggest problem the Bank of Slovenia faced in assessing the probable impact of a flat tax in Slovenia was in determining the

possible response from low-paid labour. The Russian (Ivanova et al. 2005) and Romanian (Videanu 2006) studies noted earlier in this chapter suggest improved compliance and a shift to the formal rather than the informal economy in this sector, following introduction of a flat tax, but the impact was relatively revenue neutral for the individuals in those cases, compared with their previous position. If, as would be the case in Slovenia (because it enjoys higher prosperity than either Russia or Romania), the average-paid worker in the formal economy was worse off under a flat tax (and the reasons for this possibility are discussed below), the possibility must exist of a shift to the informal economy, contrary to the Russian and Romanian trends. As a result these researchers conclude that: 'a flat tax reform will prove inferior in terms of welfare and often times in terms of production and consumption with respect to its competitors' (Kozamernik 2006).

Alvin Rabushka does not agree. When interviewed for this report he said:

The general thesis of those who argue for low rate flat taxes… is that the economy would get a supply side kick and a supply side kick would mean that more economic activity is being generated and that, to the extent that a proportion of it is taken off in taxes in absolute amounts, the government will collect more not less – but it wouldn't necessarily collect more as a share of GDP.

It appears, therefore, that there is insufficient evidence to prove the flat tax hypothesis.

Tax avoidance and evasion are discouraged

The argument for this is well put by Richard Teather (2005):

A simpler tax system reduces the scope for legal tax avoidance by removing many of the deductions, thresholds and anomalies on which most avoidance is based, and makes enforcement of taxes easier, reducing the possibility of illegal tax evasion. In addition replacing a system of higher rate taxes with a single, low, flat rate reduces the motivation for avoidance.

The Russian and Romanian studies noted earlier in this chapter provide some evidence to support this argument. Ivanova et al. (2005: 408) also note, however, the counterintuitive logic that reduction in tax rates can encourage an increase in evasion. Citing earlier studies, they note: 'in Allingham and Sandmo's (1972) model of tax evasion as a gamble, if the fine in the event of being caught increases with the amount of tax evaded then, as shown by Yitzhaki (1974), a cut in the tax rate actually leads to an increase in the extent of evasion'.

Most, however, accept the logic that tax cuts are likely to produce some increase in compliance behaviour. Professor Mike McIntyre of Wayne State University, when interviewed for this report, however, counselled caution for different reasons. He suggested that flat tax rates are unlikely to be at the level currently publicly proposed, saying that Hall and Rabushka:

used a 19% rate as if that would raise the revenue and then you look in their book and say 'how did you get 19%, that creates a huge deficit?' and they say 'well we're expecting economic miracles to result from our tax.' Well, fine…. When people did the numbers in the [US] *Treasury where they had to live with the result they were talking in the high twenties and that was with a very broad base and getting rid of loopholes that would be politically very difficult to do.*

As a result, he thinks a flat tax rate would have to be set at a level of at least 30% (an issue discussed below). In that case he said: 'I don't think you get people lining up to pay a 30% tax and I do think people will try to evade a 30% tax'.

In McIntyre's opinion:

At low levels of income, evasion is done because it is just too expensive to collect little amounts of tax from

people… At the high end of the income scale it is a detection problem… There is no doubt we could collect at the low end if we put the resources into it but why would we want to? The distributional effects are not significant enough. You want to do the best you can and we could do better than we do but flat tax does not help at that end anyway… Obviously a lower rate of tax reduces the incentive to evade; you save more money evading a 50% rate than a 30% rate. However, that said I don't think there's huge gain from flat tax in that respect.

He added:

Evasion in the US is not on wage taxes, even for the rich. There's some leakage there but it isn't bad. The big leakage is on investment income. It's disingenuous to say you have solved the problem of evasion of investment income because you have exempted it [from tax].

Alvin Rabushka argued that:

If you have a 40% income tax rate rather than a 20% income tax rate, the temptation and the benefit from trying to convert ordinary income into capital gains [as an example of avoidance] *is of course substantially greater as the reward is substantially greater. You will never clear up 100% of the problem but you certainly make some steps forward* [with a lower rate].

Howard Reed at The Institute of Public Policy Research (IPPR) has a different perception since he thinks such large rate shifts are unlikely. When interviewed he said:

I think there is something in the tax avoidance thing when rates are very high. A lot of empirical work in the UK shows that when we had rates as high as 83% avoidance rates were very high. They were probably still high at 60%. But when you're going from 40% to 33% then I don't think it will have the same impact… It would seem surprising to me if you were getting huge impacts on the extent of avoidance from marginal rate changes in the 30%–40% area.

There is some evidence to support the view that low tax rates do not stop tax avoidance. Jersey, in the Channel Islands, has probably enjoyed what at least looks like a flat tax for the longest period in the world. It has had the same 20% income tax rate on both personal income and corporate profits since 1940. Jersey also has quite a simple and short tax code, does not tax the offshore income of companies not owned by Jersey residents, has no VAT at present (although one is scheduled to be introduced) and has no capital gains tax or inheritance tax. It is not surprising, perhaps, that Steve Forbes has offered enthusiastic praise for the Jersey tax system (Forbes 2005: 105).

The 20% tax rate in Jersey has not, however, stopped tax avoidance. To tackle the problem Jersey has one of the few general anti-avoidance provisions apparently in common use, in the world. It is section 134a of the Income Tax (Jersey) Law 1961, *General Provision Against Legal Avoidance*.[34] The title is, in itself indicative of what the section is used to attack, which is the recategorisation of income to make it non-taxable in Jersey. Such an exercise would, for example, recategorise income as capital gains, which are untaxed. In 2004 this provision was used by the tax authorities in more than 400 cases.[35] Jersey has a tax base of about 80,000 (60,000 people at most and possibly 20,000 tax-paying corporations), which

[34] The main part of this section states:
'If the Comptroller is of the opinion that the main purpose, or one of the main purposes, of a transaction is the avoidance, or reduction, of the liability of any person to income tax, the Comptroller may, subject as hereinafter provided, make such assessment or additional assessment on that person as the Comptroller considers appropriate to counteract such avoidance or reduction of liability'.
Source: <http://www.gov.je/TreasuryResources/IncomeTax/Legislation/Income+Tax+%28Jersey%29+Law+1961/Part+XXA-GeneralProvisionAgainst+legal+Avoidadance.htm>, accessed February 2006.

suggests that the provision was applied in one in 400 cases. This suggests that low tax rates do not stop tax avoidance.

Proposed changes in Jersey's anti-avoidance provisions do not provide that confidence either. It is expected that from 2008 all Jersey companies will pay tax at 0% but local resident shareholders will have the earnings of their companies attributed to them, on which attributed income they will pay income tax (State of Jersey 2005). In many ways this move takes Jersey closer to the flat tax ideal by integrating the income tax and corporate profit tax base while exempting non-resident income from tax, but the move has given rise to suggestions that a significant extension in Jersey's anti-avoidance measures might be required to prevent abuse of the scheme. PricewaterhouseCoopers have described the potential measures required to tackle that abuse as 'draconian'.[36] It seems that those in authority in Jersey do not believe that low tax rates stop tax avoidance. Instead, they apparently believe that the creation of multiple tax rates, some being at 0% (which is a concept inherent in the flat tax system designed by Hall and Rabushka) increases the scope for, and risk to the revenue from, tax planning and avoidance.

In the circumstances there is a shortage of conclusive evidence that flat taxes reduce either the incentive for or the incidence of tax avoidance and evasion.

[35] Information supplied to the author of this report while he was an adviser to a Scrutiny Committee of the States of Jersey in summer 2005.

[36] See Jane Stubbs (2005), 'No ticks for the tax man', *Jersey Evening Post*, April. Online article <http://www.thisisjersey.com/businessreview/showbusinessreview.pl?ArticleID=000024>, accessed 18 May 2006.

Flat taxes increase the taxation revenues of government

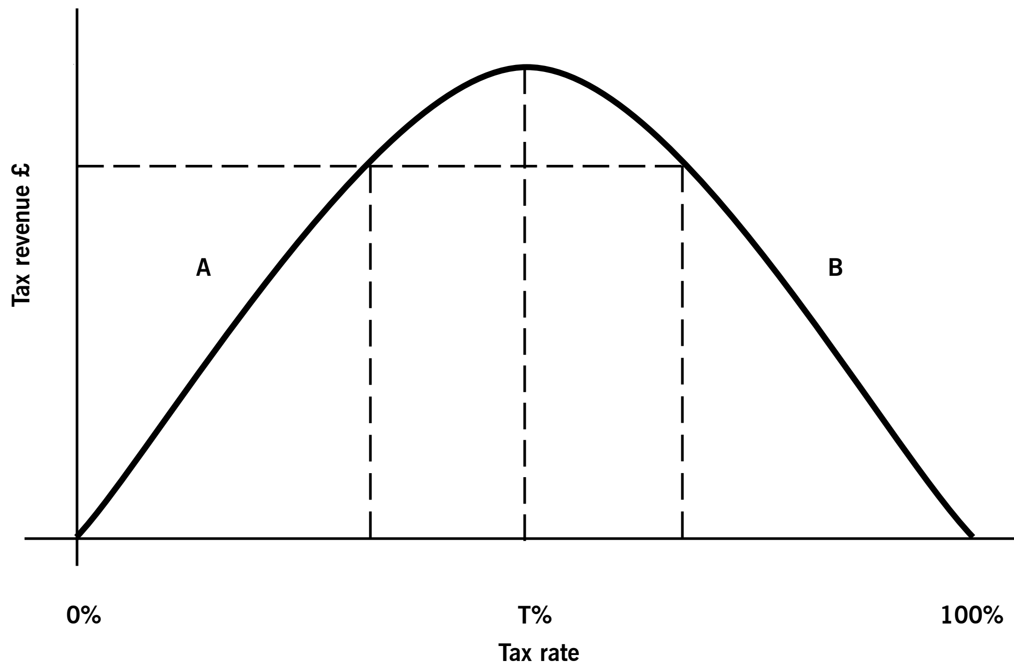
This is one of the more contentious claims made for flat taxes. The theory is that of the 'Laffer curve' (Grecu 2004), named after but not invented by US economist Richard Laffer.[37] The curve (see p. 37) apparently shows that governments can maximise tax revenue by setting a tax rate at the peak point of the curve and that raising tax rates thereafter reduces tax revenues. The logic is that the disincentive effect of tax paid does, above a certain tax rate, reduce effort expended by the taxpayer. It suggests that at 0% no tax is collected, and this is, of course likely. It also suggests that at a 100% tax rate, the same outcome will result because people would not work.

The optimal tax rate (T%) is at the peak of the curve, and it will be noted that a fixed level of taxation revenue can, according to this idea, be raised with two taxation rates at all levels bar the optimal rate. It must be stressed that there is no reason why the curve is evenly shaped as shown. T% could be anywhere between 1% and 99%.

The Laffer curve was much discussed in the 1970s and 1980s but a literature review suggests it has been less studied since then. This might be because: 'There is now a pretty solid literature on this topic, both empirical and theoretical, not to mention almost wholly critical'. (Middleton 1997)

[37] The Laffer-curve term was reportedly coined by Jude Wanniski (a writer for the Wall Street Journal) after a 1974 afternoon meeting between Laffer, Wanniski, Dick Cheney, and his deputy press secretary Grace-Marie Arnett. In this meeting, Laffer reportedly sketched the curve on a napkin to illustrate the concept, which immediately caught the imaginations of those present. Laffer does not claim to have invented the concept, attributing it to a fourteenth-century Islamic scholar, Ibn Khaldun and, more recently, to John Maynard Keynes. (Source: <http://en.wikipedia.org/wiki/Laffer_curve> but other sources confirm the story.)

Figure 4.2: The Laffer Curve



Middleton concludes his survey on the economic evidence for and the political impact of the Laffer curve in the UK thus: 'It appears…both as a construct in political economy and as a demonstrable economic relationship, the Laffer curve in Britain is conspicuous more by its absence than by its presence' (ibid).

This conclusion appears similar to those of many who have looked at the suggested phenomena. Professor Mike McIntyre, interviewed for this report, was more scathing. He said:

The Laffer curve is a joke. I don't accept any of the premises of it. I can believe that in some circumstances a tax can get so high that lowering the rate will increase revenues; that I can believe. But I don't believe it is a feature of most taxes. The curve that he [Laffer] *draws suggests it is a feature of every tax. I don't think it is right that in the graph it suggests that if you have a 100% rate you don't collect anything. We have often seen a rate on interest income in excess of 100% in real terms because of inflation and we raised revenue from it. So, in many cases 100% won't raise you revenue, but it isn't always true and so you shouldn't take that as a fixed point. Once you move beyond that, you haven't any idea where it will bend and it may well bend at different rates for different taxes. So what is he saying? You're just saying that at some point a tax can be so high you'd be better off lowering the rate. That's true but the point of the curve was that it happened somewhere in the middle range, not at 98% but somewhere in the 40s or 50s or 60s and you're getting a little vague there and none of those curves were drawn so that the up side lasted until you get to 98% and then at the very last minute it bends down. That's not the Laffer curve, the Laffer curve is this protuberance that bends back in the same way and this is an experience that no live person would ever have.*

Empirical evidence to support the Laffer curve thesis as commonly drawn is hard to find. Even a rare enthusiast for the thesis (Davidson 2005) notes: 'The infamous Laffer curve suggests that at certain tax levels, a decline in tax rates could lead to an increase in tax revenue…I argue it is likely Australia is on the 'wrong' side of the Laffer curve. In other words, a decrease in tax rates could lead to an increase in tax revenue'.

This argument suggests that McIntyre is right in his assumption that those who support flat taxes must presume that at the present tax rates, current tax systems fall in the area marked B on Figure 4.2 This means that for a country such as the UK the optimal tax rate must be lower than its current highest marginal rate of 40%. This view is supported by the fact that most proposed flat tax rates are in the range starting in the mid teens and ending in the low 20s. Robert E. Hall, co-founder of flat tax with Alvin Rabushka, suggests that 'The [European] VAT is efficient because its rate is in the safe zone below 30 percent' (Hall 2004). It is clear that he thinks that taxes set above that rate would not be efficient on the Laffer curve.

Alvin Rabushka agrees. When interviewed he said: 'I like flat tax regimes below 20%; I don't like flat tax regimes very much above 20%'.

When asked to discuss this opinion in the context of the Laffer curve he said:

Conceptually [Laffer] *does not work for me. You could continue to raise tax revenues from your GDP in Britain maybe to 47% or 48%, maybe 50% and I don't know what number is going to reach the top of the Laffer curve, it varies from country to country* [but] *you have something quite unique in your country. You have a whole category of people who don't pay income tax who generate a whole lot of wealth; you know the City and the non-domiciled people who escape UK income tax who earn and spend a lot of money here and you could be getting more of those people who continue to generate wealth and hire people and they pay income tax and consumption tax and God knows what else so it is hard to know exactly what those numbers are and what they mean but it seems to me that that's the wrong way to think about it anyway.*

Despite that, people do look at this as an issue. In December 2005, the Congressional Budget Office (an agency of the US Congress) tested what the impact of a 10% reduction in all federal tax rates might be on individual income (CBO 2005). A wide range of assumptions were tested to ensure a range of alternative opinions on the reactions to such a change in the tax system were modelled. Their report states:

[u]nder those various assumptions, CBO estimated effects on output ranging from increases of 0.5 percent to 0.8 percent over the first five years on average, and from a decrease of 0.1 percent to an increase of 1.1 percent over the second five years. The budgetary impact of the economic changes was estimated to offset between 1 percent and 22 percent of the revenue loss from the tax cut over the first five years and add as much as 5 percent to that loss or offset as much as 32 percent of it over the second five years.

Their conclusion might be summarised as suggesting that the impact of a tax cut on growth would be limited and that a 10% tax cut would significantly reduce tax revenues. The possible interpretations are that the US is in fact on section A of the curve so that a tax cut reduces revenue, or that the optimal rate is between the two levels tested, ie current rates are just in part B, and a cut of 10% takes them over the peak and down part A of the curve. The use of a range of assumptions appears to suggest the second alternative is unlikely.

The evidence from Eastern European countries that have introduced flat taxes is unclear. There is good reason for this. As Richard Teather said in an interview undertaken for this report: 'the main problem in Russia was that people who should have theoretically benefited weren't actually paying their taxes [before a flat tax was introduced]'.

Slovakia has been examined to assess the possible impact of a flat tax on a state that was not previously in a state of taxation disorder. Unfortunately, Slovakia does not help the making of such comparisons. No final outturn taxation data for 2003 from reliable sources appear to be available for Slovakia and Slovakia's own review of the results of its 2004 tax reforms compares only the actual results for 2004 for the budgeted results for that year, which is of little benefit when assessing change from the previous year. As a result, the work of Peter Golias of the Institute for Economic and Social Reforms and Robert Kièina, of the Business Alliance of Slovakia has been used instead (Golias and Kièina 2005). They suggest that tax revenues in Slovakia in 2003 and 2004 were as shown in Table 4.1.

The implication of this table is clear; total revenues rose after the change in taxes in Slovakia, but not for the reasons that might have been predicted. Figure 4.3 (see p. 40) shows the total tax revenues for each tax in each of these years.

As will be noted, all the income taxes saw a decline in their revenue after the introduction of flat taxes. VAT and Excise duties saw an increase. These findings suggest that Slovakian tax rates were on the upward sloping part of the Laffer curve and that the cut in rate was not efficient for the generation of tax revenues.

The findings are similar to those from Romania noted in Table 4.1, where direct tax revenues were constant or fell but indirect taxation revenues rose. Rises in indirect tax revenues were also noted in Russia. In

Table 4.1: Tax revenues in 2003 and 2004 (in SKK billion on accrual basis)

	2003 (before reform)		2004 (after reform)	
	Reality	Share of total	Reality	Share of total
Tax revenues	217.6	100.0%	233.5	100.0%
Direct taxes (PIT & CIT & WIT)	82.7	38.0%	68.9	29.5%
Personal income tax (PIT)	39.9	18.3%	34.1	14.6%
Corporate income tax (CIT)	33.6	15.4%	29.1	12.5%
Withholding income tax (WIT)	9.1	4.2%	5.7	2.4%
Indirect taxes (VAT & Excise)	118.3	60.9%	149.5	64.0%
VAT	80.7	41.9%	104.9	44.9%
Excise duties	37.6	19.0%	44.6	19.1%

Source: Golias and Kièina (2005) citing Ministry of Finance of the Slovak Republic.

each case this might suggest that the argument that these countries were previously on the descending slope of the Laffer curve (section B on Figure 4.2) is weak.

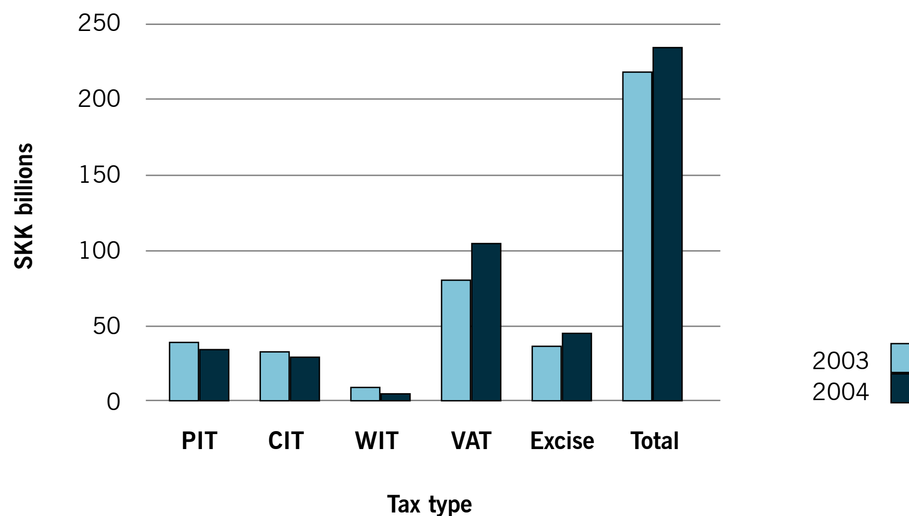
Heijman and van Ophem (2005) suggest that this is likely. As they note: 'Our approach, which is unusual in the field of Laffer curve studies has been to develop a theoretical model and test it'.

As they continue, 'many recent studies in this field are purely theoretical or theoretical-mathematical'.

The model they tested sought to determine whether the tax rates in 12 OECD countries were above or below the optimal rate to encourage legitimate economic activity. The countries were largely Western European, including the UK, but Japan was also in the sample. Despite its recent publication, the data used relate to the mid 1990s but, although there have been general falls in personal tax rates since that time, their conclusions are still interesting. They suggest that in all countries but Sweden the optimal marginal tax rate was higher than that actually in use. In the case of the UK they calculated the optimal tax rate (T% on Figure 4.2 on page 39) to be 54%, which is above any marginal tax rate seen at the time the data were collected, or now (even if national insurance were included). Their evidence suggests that the Laffer curve does not provide a reason for cutting tax rates as those who propose flat taxes believe.

Therefore further arguments for and against flat tax need to be explored. Many of these are more subjective in their nature, and border on areas where political judgement is required to choose between the competing claims. In a democracy, when it comes to taxation such choice is frequently influenced by the likely economic effect of any proposed change. In Section B, this is explored further by looking more closely at issues for consideration in the UK.

Figure 4.3: Slovakia – Tax Revenues 2003–04



Note: PIT = personal income tax, CIT = corporate income tax and WIT = withholding income tax.
Source: Golias and Kièina (2005).

Section B: UK implementation

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5. The impact on UK taxpayers

Reasonable criteria for assessing the impact of any tax change might be:

- its ability to raise revenue
- its ability to do so without making any existing taxpayer significantly better or worse off
- its impact on the overall distribution of wealth within the economy.

The first issue has been considered in Section A, with regard to the impact of flat taxes in other countries. This section, Section B, of the report will consider that issue in a UK context.

The second issue is pragmatic but the possibility that the introduction of a flat tax may not result in the tax savings many people seem to expect of it must be explored.

The third issue relates to social policy. The UK has, since the Second World War, presumed progressive taxation to be a key element of social policy. Put simply, a progressive tax takes an increasing proportion of tax out of a person's income as that income rises; a regressive tax does the reverse and a neutral tax seeks to hold that ratio constant. Neutral taxes are sometimes called proportional taxes because they take a constant proportion of income.

Hall and Rabushka argue that their flat tax is progressive (1995: 31), because it is applied to all income above an agreed exempt level, and that exempt level guarantees that the overall proportionate rate of tax is progressive. There are, however, several critical assumptions that must hold true for this argument to work:

- all income must be taxed
- there must be no allowances and reliefs apart from the exempt amount
- the tax must not, in combination with other taxes, make a regressive tax system. After all, it is the overall system that matters at the end of the day to the individual taxpayer, not each separate component of it.

If these assumptions hold true then Figure 5.1 (p. 43) could be drawn.

It is assumed in drawing this graph that:

- the flat tax rate is 20%
- the annual exempt sum is £10,000.

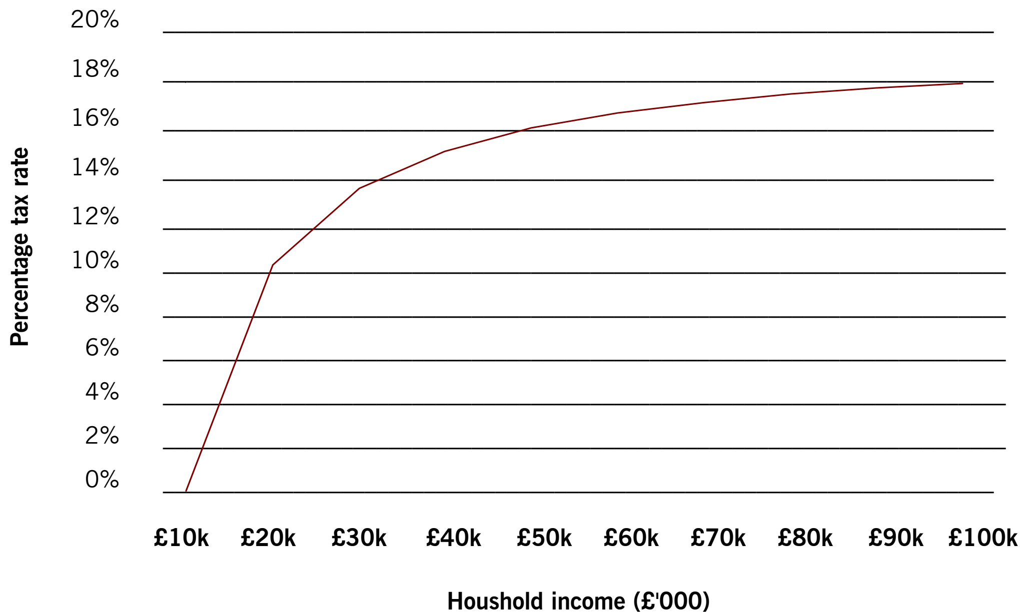
Average tax rates rise rapidly as the exempt level is passed, but on the basis of these simple assumptions the tax rate is consistently rising as a proportion of the tax base so the flat tax appears progressive.

There are, however, problems with this simple conclusion.

- The terms progressive, regressive and neutral are normally assumed to apply to the proportion of tax paid in relation to income. It is unusual for another definition to be used,[38] but in a pure flat tax there is no tax on investment income (Hall & Rabushka 1995). As a result it is not true that all income above the exempt amount is subject to tax. Therefore those who claim flat taxes are progressive do so in comparison with consumption, and that is unconventional and consequently might be considered misleading.

[38] For example in Bannock et al (1984), progressive taxation is defined as 'A tax which takes an increasing proportion of income as income rises'. Consumption is not mentioned.

Figure 5.1: Effective flat tax



- There are no allowances or reliefs under a theoretical flat tax, but, as has already been noted, there is an exemption for income from overseas. This means a source of income that could fund consumption is not taxed and one cannot determine whether the tax is progressive with regard to consumption because that consumption may be funded out of non-taxed income.

- A flat tax might result in the abolition of income tax, capital gains tax, corporation tax and inheritance tax in the UK but it would not displace national insurance charges and nor would it displace the main existing consumption taxes, such as VAT and excise duties. These taxes have to be taken into account when appraising flat tax.

This section considers whether, given these facts, a flat tax might be progressive, neutral or regressive.

The general assumptions used are as follows.

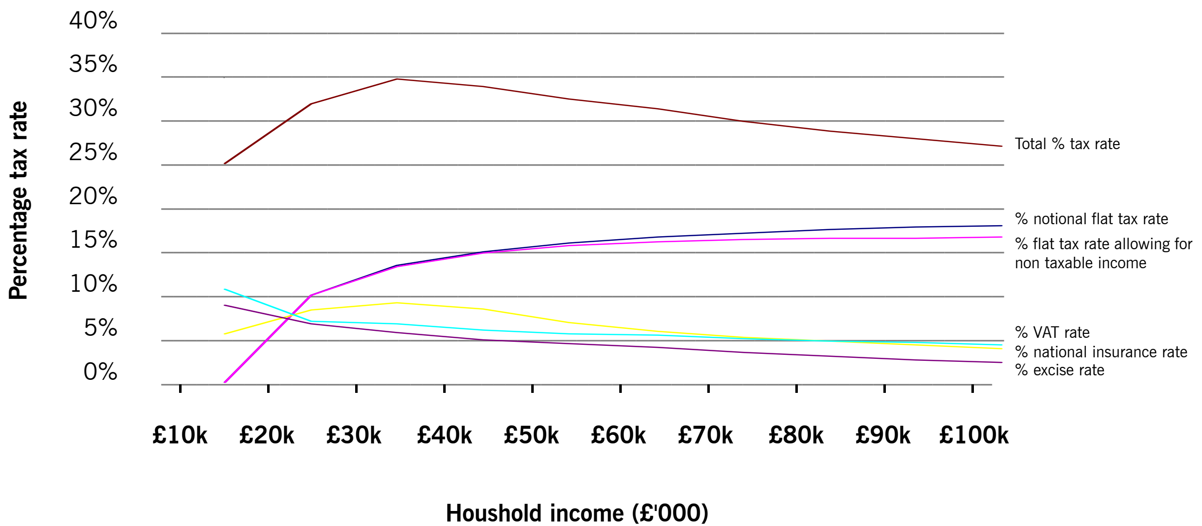
- Income is tested at £10,000 intervals from £10,000 to £100,000. Income of £100,000 puts a person well into the top 2% of income earners in the UK.[39]

- A flat personal allowance of £10,000 is used; this is approximately double that currently available to an individual and is consistent with the normal suggestion (Hall and Rabushka 1995) that flat tax systems significantly increase personal allowances.[40]

[39] National Abstract of Statistics Table 8.1, 2005 Edition, UK National Statistics Office.

[40] Richard Teather in an interview undertaken for the purposes of this report has questioned whether this is in fact an essential element of a flat tax, but it is assumed to be for the purposes of this discussion.

Figure 5.2: Effective tax rates



- A flat tax rate of 20% is applied; this would represent a reduction in the UK basic rate of tax of 2%, so providing a potential benefit from a flat tax for most taxpayers. This would appear psychologically important if marginal tax rates are as significant as flat tax theory suggests.

- Household income is initially attributable to one income earner.

- Part of the income of the household is not taxable since it is derived from savings and other categories on which tax is not charged. This proportion rises from 0% at £10,000 and £20,000 to 12% at £100,000 of income, with 0.5% of income not being taxed at £30,000 of income, increasing to 1% at £40,000 and increasing at 1% for each extra £10,000 of income earned.

- National insurance calculations assume that all taxable income is derived from employment. £5,000 of income is free from contributions and national insurance is not charged above income of £35,000. The rate between the lower and upper limits is 11%.[41]

- VAT is charged at 17.5%, which is the current UK standard rate.

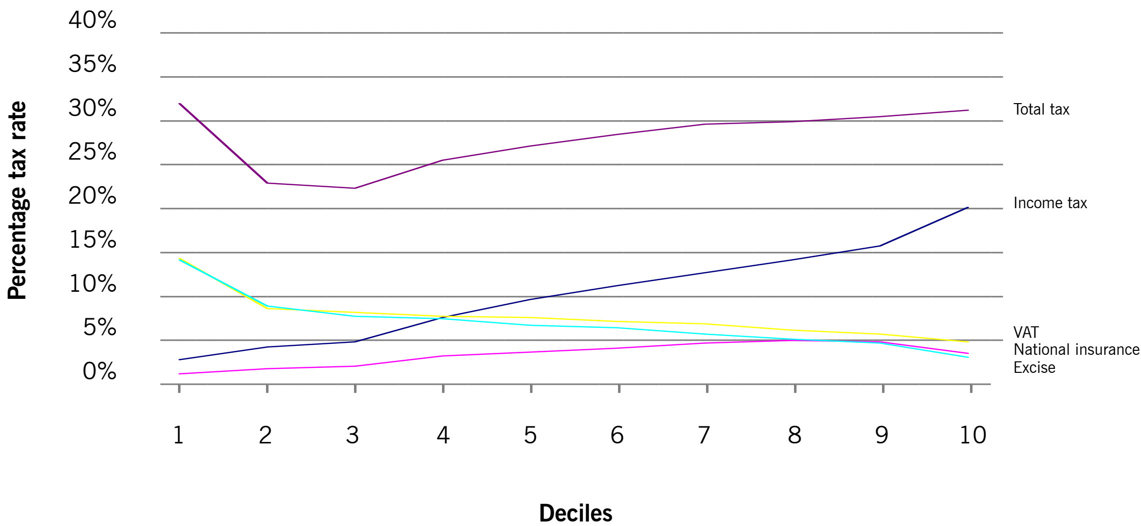
- The proportion of expenditure of the household disbursed on consumption is reduced as income rises, as shown by Lakin (2004).

- The proportion of household income spent on excise duties again broadly matches Lakin's findings (2004).

- Local taxes are ignored.[42]

[41] These assumptions closely approximate to UK contribution rates in 2005/6.

Figure 5.3: UK actual tax burdens



Using these assumptions, all of which, except for those relating to flat tax, reflect the current UK tax system, then the total tax burden of these four taxes (which together comprise 69% of total government revenues[43]) borne by a single income household are as shown in Figure 5.2.

Under these rules a flat tax appears progressive, but in combination with other taxes, and especially national insurance and excise duties, the combination of taxes is progressive until a peak combined rate of 34.1% is reached between income levels of £30,000 and £40,000, after which the rate declines to 29.7% on income of £100,000.

Using data relating to the same taxes from Lakin (2004), Figure 5.3 is found for income per decile.

[42] If they were to be included it is likely that the lowest decile would be shown to pay more tax. This is the finding of John Hills in Inequality and the State, Oxford, 2004.

[43] Ibid.

The deciles in question have their mid points at the income levels shown in Table 5.1.

Table 5.1: Income level at mid point of each decile

Decile	Income
1	£2,735
2	£5,330
3	£7,462
4	£11,763
5	£16,830
6	£21,801
7	£29,303
8	£36,865
9	£46,040
10	£74,585

Figure 5.4: Effective flat tax rates using 2002/3

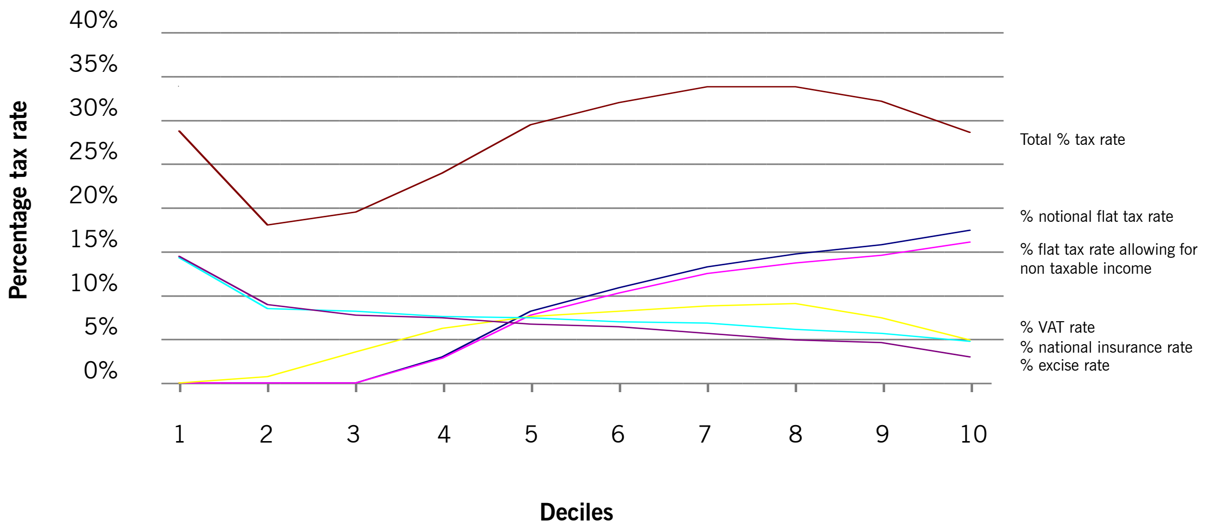


Figure 5.5: Flat tax *v* actual tax 2002/3

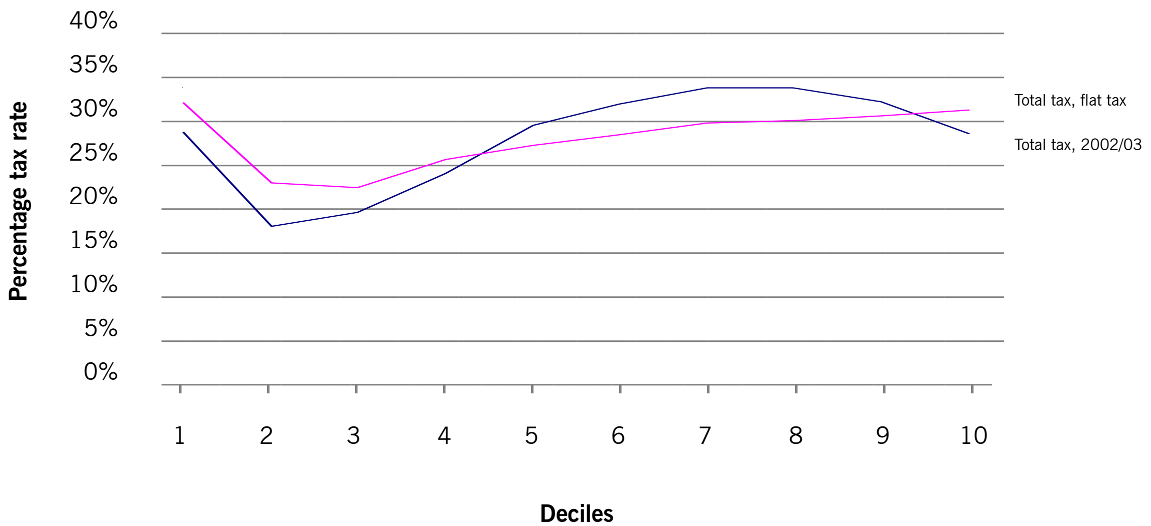
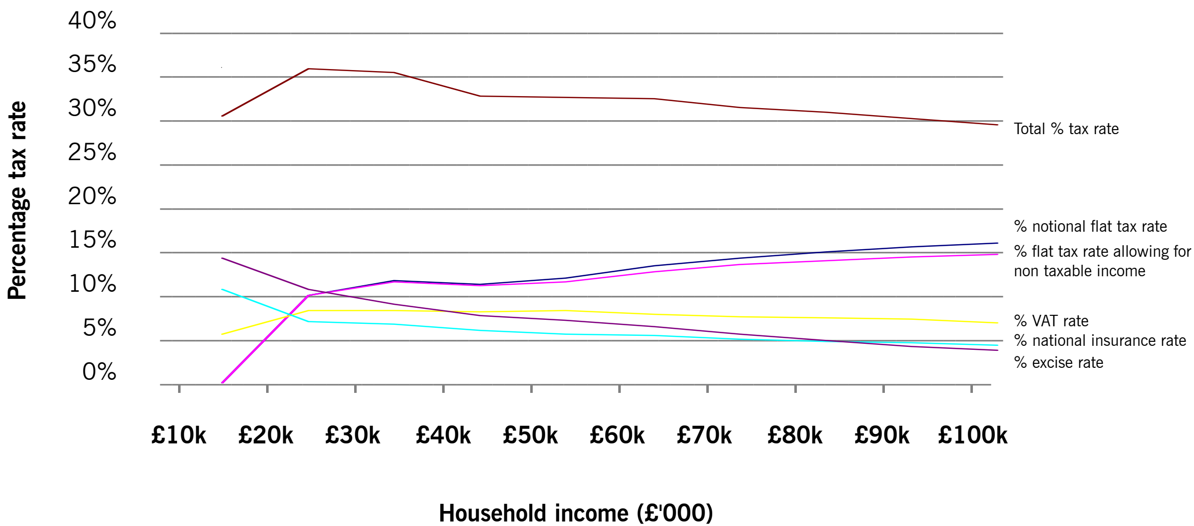


Figure 5.6: Effective tax rates



If the same income points were to be placed into Figure 5.2 then Figure 5.4 would result.

If the liabilities due under flat tax are compared with those due under the existing tax system the pattern is clear, as Figure 5.5 shows.

Flat taxes would suit the less well off on the basis of the assumptions used. A break-even point would be about £22,000. Above that sum flat tax imposes a greater burden than existing tax systems until income of around £75,000 per annum is earned. At that point flat tax begins to reduce overall burdens of tax, and this trend of falling tax rates with rising income continues thereafter.

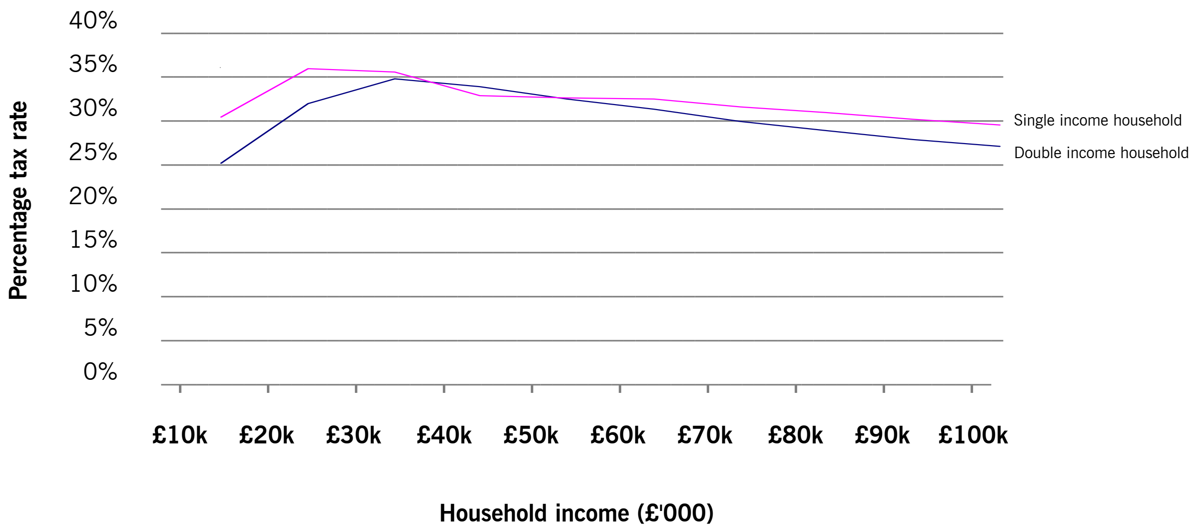
It is curious to look at Figure 5.1 again and see what happens if a household is assumed to have two income earners. It is assumed that until £25,000 of income is earned the household has only one earner. When the second earner commences employment it is assumed that they earn half of all additional household income, ie for each additional £10,000 of household income half is attributable to each income earner. It is assumed that all the second income earner's income is subject to national insurance. It is assumed that excise duties paid increase by 80% to reflect the additional consumption of a second adult. Other assumptions are held constant. Figure 5.6 results.

The pattern is somewhat different from that for a single-person household, as Figure 5.7 shows.

Households that require two income earners to achieve an overall level of income, almost without exception pay higher overall rates of tax under a flat tax system than do households with one income earner achieving the same level of income. There are three reasons for this.

1. Consumption taxes operate on a per capita basis, ie the amount paid rises broadly in line with the number of people in a household.

Figure 5.7: Single *v* double income household



2. National insurance is a regressive tax in that income over £35,000 is almost free of tax, favouring an individual taxpayer.

3. The double allowance available under a flat tax is not big enough in this example to counter that trend even though the level of allowance assumed is double the level currently enjoyed under UK income tax laws.

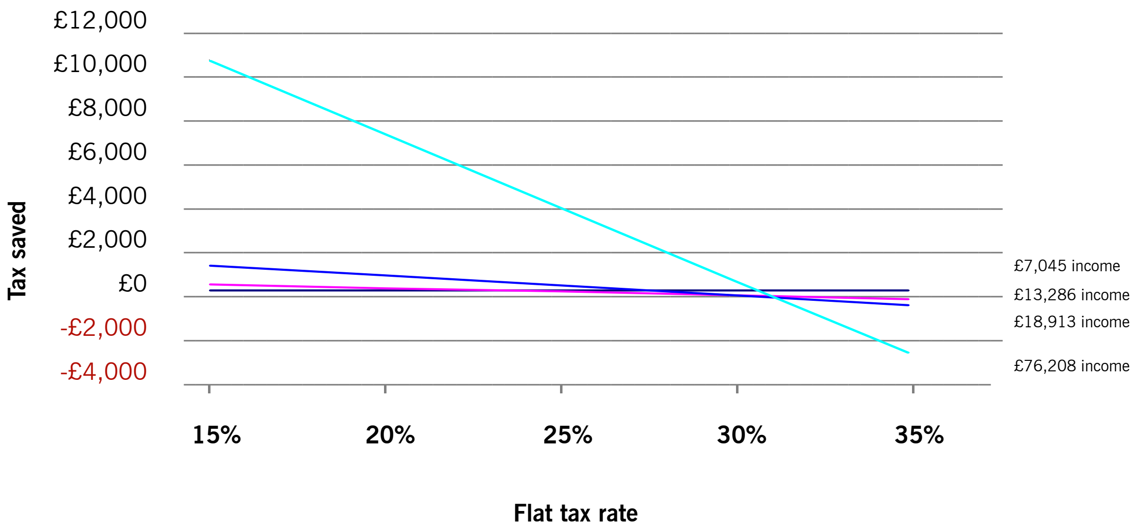
This rule is broken only where the second earner has a modest income not subject to flat tax and only very low levels of national insurance apply.

INITIAL CONCLUSIONS

This review produces the following initial conclusions.

- By themselves flat taxes can be progressive.
- Taken within the context of other UK tax laws, which would not be affected by flat tax reform and which are all regressive, the tax is not sufficiently progressive to prevent the system as a whole from being regressive.
- Although those on below-average earnings might benefit from flat taxes, middle-income earners would undoubtedly lose out under a flat tax system of the type modelled here.
- High-income earners would always benefit from a flat tax system.
- Dual-income households would not benefit from flat tax systems as much as single-income households with the same level of earnings because of retention of the regressive national insurance system.

Figure 5.8: Impact of flat tax on tax paid by income bracket



FURTHER TESTING

The model created was tested further to determine whether a change in the assumptions with regard to flat taxes could alter the outcomes. The following findings depend on decile information based on Lakin's work (2004) and assume a single income earner.

- An allowance rate of £15,000 ensured flat taxes were always lower than equivalent taxes in 2002/3 for all deciles except income categories 7 and 8, being those earning in the range £30,000 to £40,000. The flat tax became regressive at the same point as it had with a £10,000 allowance.

- A 25% flat tax and an allowance of £10,000 provided a benefit to people with earnings below £20,000. Thereafter more tax was paid by all taxpayers within the range reviewed under a flat tax system, but with total combined rates falling once income of £40,000 was reached, ie once again mid-range earners were hit hardest.

- An allowance of £15,000 and a rate of 25% meant all income earners below £26,000 were better off under a flat tax system. Those with earnings above £75,000 also benefited from flat taxes. Those in between did not, ie a higher allowance and higher rate spread the income range where flat taxes increase the total tax burden, but the rich and poor always benefit.

These types of conclusion are not exclusive to the UK. At the conference on flat taxes held in Bled, Slovenia on 3 and 4 February 2006, officials from the Ministries of Finance in both the Netherlands and Denmark made presentations on the possible impact of flat taxes within their countries (Heineken 2006; Larsen 2006). Both showed remarkably similar trends to those found in the survey for the UK conducted for this report. The conclusions appear clear. In the tax systems of developed countries such as the UK, flat tax systems might benefit the poor a little, cost middle-income earners additional tax paid and benefit the well off. This is shown by Figure 5.8, based on data calculated using the methodology above.

In absolute terms, and until a flat tax rate reaches levels approaching the highest marginal levels already in use, the best off always benefit most in absolute terms.

Richard Teather (2005) disputes this. He says: 'This is not a tax break for the rich; those on below-average earnings would see their after-tax income increase by over 12%, while the average benefit for the top third of earners is barely 0.5%'.

After being interviewed for this research he updated this conclusion, which was based on 2001 data, and said that when using 2003/4 data the benefit to the after-tax income of below-average earning households would be 8%, not 12%. He added that when he looked at the figures: 'the one that shocked me was that the effective rate of tax for the top 10% of earners was barely above the current basic rate'.

Teather concludes this on the basis of information published by National Statistics (National Statistics 2003–04) and bases the comments in his report on an analysis of the same data, which he supplied for the purposes of review. Unfortunately these data are inappropriate for the purpose for which Teather has used them and so his conclusions are misleading for two reasons.

1. The data produced by National Statistics show total net income tax paid of only £100 billion in that year. The actual income tax paid in 2003/4 was £114 billion (HMRC 1.2, 2005).

2. If the percentage of the tax burden is attributed to deciles, on the National Statistics data the percentage paid by the top decile is 39%. According to HM Revenue & Customs (HMRC 2.4, 2005) the top decile paid 51% of total tax liabilities in that year. The top 1% paid 21%.

It is apparent that the National Statistics survey data did not include sufficient of the top 1% of households to weight the data to show their importance in relation to total tax paid, so under-recording the tax paid by the group and their effective tax rate. If the data are corrected so that the missing £14 billion of tax is added back into the tax paid, and is all attributed to the top decile of taxpayers, then their effective tax rate is 26.9%, in contrast to the 19.9% Teather calculates. In addition, that decile still pays only 47% of total income tax on this basis. If the decile data were to be adjusted so that the top decile pays the tax that HM Revenue & Customs say they did pay, then a further £4 billion would have to be moved from the sixth to ninth deciles and be reallocated to the top decile. In that case their tax burden would be 28.7% on average incomes of £81,700, at an average of £23,501 each. This compares to the liability of £24,924 on that income which would be calculated using the headline tax rates for that year. Once this is done it is clear that the rich are not using tax reliefs and allowances, as Teather implies, to reduce their liabilities but that the data he used to reach this conclusion were inappropriate for the use he made of them. In fact, on average the top decile may reduce their tax liability by just 5.7% in total, or by just 2.3% of their effective marginal tax rate by using allowances and reliefs.

The conclusions he reaches about the benefits to the poor are also misleading. The data with which he compares his tax saving are for income from employment. In most of the households in the bottom five deciles to which he refers as being 'on below-average earnings', this figure for income from employment is substantially less than either taxable income or total income, since it excludes non-taxable benefits received and taxable benefits such as retirement pensions from the State. In the lowest decile these constitute 66% of total income and therefore his conclusion is flawed. Using corrected data (and considering only income tax effects), at best, those with total incomes below his personal allowance limit of £12,000 are 3.8% better off, being an average of about £438 a household, while those on the highest level of earnings (taken to be the top decile) are, with the corrected data, 9.9% better off, giving an average saving of £8,129. Those from the fifth to ninth deciles

(having incomes in the range £22,000 to £47,000) are all worse off under Teather's flat tax using these data, and this reproduces the findings noted above. In the circumstances, Teather's claim (2005) that 'this is not a tax break for the rich' appears to be incorrect.

The findings of Andreas Peichl support this view (Peichl 2006). In his analysis of the likely implications of a flat tax on the German economy he calculates that the Gini coefficient[44] for Germany would increase if a flat tax were to be implemented. This means that the degree of inequality in German society would increase if a flat tax were introduced.

Alvin Rabushka accepted this premise when interviewed for this report. He said: 'People who say there are losers assume you can't cut the government's spending … and that's just ridiculous'.

When questioned about what he meant and whether the fact that those on middle incomes always appear to lose from flat taxes was of concern to him he said: 'Good, this will encourage them to work harder and to become part of that upper income group. The whole point of a low simple flat tax is to encourage work, saving and investment and entrepreneurial risk taking'.

He continued:

The only thing that really matters in your country is those 5% of the people who create the jobs that the other 95% do. The truth of the matter is a poor person never gave anyone a job, and a poor person never created a company and a poor person never built a business and an ordinary working class guy never drove economic growth and expansion and it's the top 5% to 10% who generate the growth for the other 90% who pay the taxes to support the 40% in government. So if you don't feed them [ie the 5%] *and nurture them and care for them at the end of the day over the long run you've got all these other people who have no aspiration for anything more than, you know, having a house and a car and going to the pub. It seems to me that's not the way you want to run a country in the long run so I think that if the price is some readjustment and maybe some people in the middle in the short run pay a little more, those people are going to find their children and their grandchildren will be much better off in the long run. The distributional issue is the one everyone worries about but I think it becomes the tail that wags the whole tax reform and economic dog. If all you're going to do is worry about overnight winners and losers in a static view of life, you're going to consign yourself to a slow stagnation.*

This is one view, but there is now increased commentary on inequality among academics. In his book *Happiness* (2004), Professor Richard Layard, an economist at the London School of Economics and a member of the House of Lords, rejects the notion that purchasing power can be equated to happiness and claims that evidence over the last 50 years suggests that this assumption is wrong (Layard 2004: ix). His argument is based on the classical economic theory that the perceived value of each additional pound earned continuously decreases (Layard 2004: 51) because an additional pound is worth more in terms of well-being generated if you are poor than if you are rich.

He suggests that modern survey research shows this to be true, for two possible reasons. First, the nineteenth-century economists to whom he refers (and in

[44] The Gini coefficient is a number between 0 and 1, where 0 corresponds with perfect equality (where everyone has the same income) and 1 corresponds with perfect inequality (where one person has all the income, and everyone else has zero income). For more information see, for example, <http://en.wikipedia.org/wiki/Gini_coefficient>.

particular Alfred Marshall) created the concept of 'marginal utility' and its associated law of diminishing marginal utility (Bannock et al. 1984). This concept suggests that the big increases in income for the well off under flat tax systems may not produce as much increase in well-being as the small increases for the poor might provide. Also, each gain must be matched by the loss to those on middle-range incomes, which will, using the principles of marginal utility, have greater equivalent value per pound lost than the gains of the well off. Until recently this economic concept was ignored, but it is now firmly established as part of the new science of happiness.

Secondly, as Layard also suggests (Layard 2004: 52), inequality issues are not mere questions of analysis: inequality matters in itself. Realising that the gap between the rich and poor has increased is enough, in itself, to make people feel worse off even if their own cash income has not changed. Flat taxes might have this effect and Layard believes this to be of importance in its own right in the assessment of happiness.

This point is now being noticed by others. In a report published by the World Bank in February 2006, the view is endorsed that poverty does, of itself, have an impact on the likelihood of growth (Perry et al. 2006). The report looks at Latin America, but it compares the fortunes of countries in that region with those elsewhere. Importantly, it assumes that poverty reduction is a desirable outcome of economic activity, and as Layard suggests, in terms of increase in total happiness that is likely to be true. Perry et al. (2006: 5) claim: 'The more novel thesis of the report is that Latin America's persistent poverty may itself be impeding the achievement of higher growth rates', suggesting that 'relatively richer and more unequal countries need both higher growth and significant redistribution if they want to make a fast and significant dent in poverty reduction' (p. 4).

The report notes that in Latin America, tax has almost no role in re-distributing income from the rich to the poor and suggests:

' In contrast, the role played by the tax and transfer instrument in developed countries is apparently much more significant. For example,… the Gini coefficient of market income in the United Kingdom is around 0.53 whereas the Gini coefficient of disposable income is much lower: around 0.35. That is, taxes and transfers reduce income inequality in the United Kingdom by 18 percentage points as measured by the Gini coefficient.' (Perry et al. 2006: 92–3)

The message in this report is clear: increasing inequality does not assist either growth or well-being, but as Peichl (2006) has shown, flat taxes increase inequality as measured by the Gini coefficient. In that case the redistribution of income that a flat tax would create might produce the opposite outcome to that its proponents suggest likely with regard to growth.

There is, however, a further dimension to this issue to be tested. Many of the models of flat tax that have been produced, including that of Heineken (2006), choose to model rates that ensure budget neutrality. This means that the model is designed to collect as much tax after a flat tax is introduced as was collected before the reform. Not all models do so, and this issue is explored next.

6. The impact on the public purse

In the UK, one of the big debating points about flat taxes has been their possible impact on total taxation revenues. This debate was fuelled by Richard Teather's suggestion (2005) that a 22% tax with a £12,000 personal allowance might reduce government income in the short term by £50 billion. He suggested this might be reduced to £35 billion if reliefs such as age allowance, untaxed state benefits, capital gains tax taper relief and if savings such as Individual Savings Accounts were abolished. £50 billion is at present about 10% of total government income (HM Treasury 2005b). Teather suggests that this would be affordable but, before considering that assertation, the potential loss of income needs to be explored.

The range of possibilities for estimates of such a loss is, in fact, wide. All will be inaccurate. If a fundamental change is made in a taxation system then there will be consequent changes in behaviour in the economy. The changes that might result have already been discussed. It is clear that modelling the probable impact of such changes is difficult, likely to be unreliable because of the range of variables involved, and might provide no greater assessment of the impact of the tax than a simple model may deliver. Indeed, as Ivo Vanasaun of the Ministry of Finance in Estonia said when interviewed for this report: 'We can't say what the impact of the flat tax was because we had so many changes at the same time and the structures of the market and the economy were changing'.

Therefore relatively simple static modelling was used for this report, partly because this appears consistent with the modelling undertaken by Teather for the Adam Smith Institute (Teather 2005), which is the benchmark for comparison.

A simple model of the immediate impact of the tax can be built using current data on taxation revenues published by HM Revenue & Customs (HMRC 2.6, 2005). The table used as a basis for the calculations refers to total income tax liabilities categorised by the taxpayer's marginal tax rate. The version used for this study was that published in December 2005 as part of that month's Pre-Budget Report (HM Treasury 2005b). The data in HMRC's table 2.6 were as shown in Table 6.1 (see p. 54).

By implication we can deduce the figures in Table 6.2 (see p. 54).

Household expenditure in the UK in the year to end September 2005 was £720 billion, a figure close enough to the implied total income noted above to imply accuracy.[45] The average income noted is within a reasonable parameter of expectation.[46]

If Table 6.2 is modified, different rates of tax can be applied to it to suggest the impact on taxation revenues of a flat tax system. Table 6.3 (see p. 54) shows the impact of a 20% flat tax if a £10,000 personal allowance were given to those with income, all other factors being held constant.

[45] National Statistics Monthly Digest of Statistics no 720 December 2005

[46] National Statistics Monthly Digest of Statistics no 720 December 2005 suggests average earnings to be £26,358. Taxable averages are less because they include pensions, which are lower than earnings from employment.

Table 6.1: Income tax liabilities by taxpayers' marginal tax rates. December 2005.

	Start rate (10%) £m	Savings rate (20%) £m	Basic rate (22%) £m	Higher rate (40%) £m	All taxpayers £m
Tax on earnings					
Start rate	288	44	4,570	647	5,549
Basic rate			51,200	19,800	71,000
Higher rate				37,300	37,300
Tax on Savings					
Start rate	43	83		5	131
Basic rate		443	1,250	243	1,936
Higher rate				1,810	1,810
Tax on dividends					
Start rate					
Basic rate	189	214	501	496	1,400
Higher rate				4,780	4,780
Allowances	-3	-24	-400	-73	-500
	517	760	57,121	65,008	123,406
Average tax paid (£)	155	930	2,610	20,500	4,22
Average rate of tax	2.2%	7.0%	13.8%	26.9%	17.9%

Source: HMRC 2.6 (2005).

Table 6.2: Income tax liabilities by taxpayers' marginal tax rates. December 2005.

	Start rate (10%)	Savings rate (20%)	Basic rate (22%)	Higher rate (40%)	All taxpayers
Implied total income (£m)	23,500	10,857	413,920	241,665	689,419
Average income (£)	7,045	13,286	18,913	76,208	23,575

Source: HMRC 2.6 (2005).

Table 6.3: Income tax liabilities by taxpayers' marginal tax rates. December 2005

	Start rate	Savings rate	Basic rate	Higher rate	All taxpayers
Average income (£)	£7,045	£13,286	£18,913	£76,208	£23,575
Average tax bill under existing arrangements	£155	£930	£2,610	£20,500	
Flat tax allowance	£10,000	£10,000	£10,000	£10,000	
New taxable income	-£2,955	£3,286	£8,913	£66,208	
Tax due @ 20%	£0	£657	£1,783	£13,242	
Tax payer saves on average	£155	£273	£827	£7,258	
Gross loss of revenue (£m)	£517	£223	£18,108	£23,017	£41,865

Source: HMRC 2.6 (2005).

Table 6.4: Tax loss from having a single flat rate of 22% with an increased personal allowance (PA) as shown

New PA (£)	Increasing PA £billion	Abolishing higher rate tax £billion	Total £billion
7,500	11.7	18.1	29.8
10,000	26.3	16.6	42.9
15,000	49.9	13.6	63.5
20,000	65.8	12.2	78.0

Derived from Inland Revenue data 2004/5 (Teather 2005).

According to these example, a flat tax rate of 20% with an allowance of £10,000 per annum attributable only to income earners (ie without allowances being transferable between partners and without additional allowances being available for children, as flat tax theory would suggest desirable) is enough to produce a loss of income tax revenue of almost £42 billion in a year. In addition, revenue will be lost from the abolition of capital gains tax (£2.8 billion[47]) and inheritance tax (£3.3 billion[48]) as well as from corporation tax, where the rate would also be 22%. The impact on corporation tax yields may be small, however, since for small companies a rate of 22% represents an increase in their nominal tax rate by 3% in many cases, while the effective rate of corporation tax paid by large UK corporations has been shown to be 22.1% in 2004 (Murphy 2006). This report assumes that there is a modest effective 2% reduction in yield resulting in reduced income of £836 million based on an expected total income of £41.8 billion in 2005/6.[49] If these losses in income are added to the lost income tax then the total loss of government revenue might amount to £48.8 billion in a year. It should be noted that this figure is remarkably close to the income that Teather expected to be lost by use of a flat tax, shown in Table 6.4 (Teather 2005).

COST OF FLAT TAX

It is interesting to note that, using the model developed for this report, if a flat tax of 20% were introduced with a personal allowance of only £5,000 the loss of revenue would be only £14.6 billion (before taking into account the loss of capital gains tax, inheritance tax and corporation tax revenues), a sum £27.2 billion less than the loss with a personal allowance of £10,000.

[47] HM Treasury 2005b.

[48] Ibid.

[49] Estimated income 2005/06, HM Treasury 2005b.

This finding supports the impression given by Teather in Table 6.4 above, which suggests, for example, that an increase in the allowance from £10,000 to £15,000 would cost £23.7 billion. The evidence seems clear that providing a doubling of the personal allowance might have a cost as high as removing higher rate taxes.

Using the model produced for this report with a tax rate of 22% and an allowance of £12,000 produces a total loss of revenue of £52 billion, which is very close to Teather's result.

Using the same table to test revenue losses over a range of allowances from £5,000 to £20,000 per annum and using flat tax rates increasing from 15% to 35% produces Figure 6.1 (see p. 57).

A flat tax can, according to these data, collect the taxation revenues that the existing tax system generates but only if:

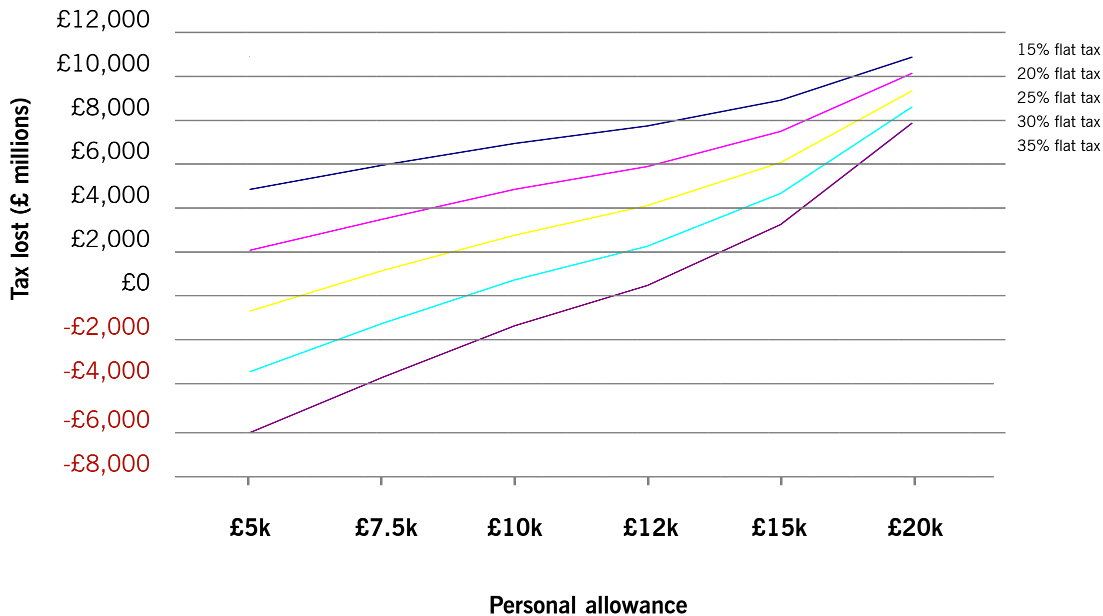
1. rates of at least 25% per annum are used, and with a personal allowance in that case little different from that currently in use

2. the allowance does not exceed £12,000 per annum (but that would require a tax rate of 35%).

Given that neither of these assumptions is likely to prove acceptable by itself then a loss of revenue is likely.

Alvin Rabushka argues that this concern is inappropriate. When, during interview for the purpose of this report he was told of the potential loss to the UK government from a flat tax calculated in this report he said: 'That's great news'.

Figure 6.1: Lost tax revenue from a flat tax



He continued:

I would rather think about human freedom and liberty.

I think we should be facing the issue of the optimal size of government. Government is too big. I think we should debate the minimum size of government, not the optimal size of government.

I think we should go back to first principles and causes and ask what government should be doing and the answer is 'not a whole lot'. It certainly does way too much and we could certainly get rid of a lot of it. We shouldn't give people free money. You know, we should get rid of welfare programmes, we need to have purely private pensions and get rid of state sponsored pensions. We need private schools and private hospitals and private roads and private mail delivery and private transportation and private everything else. You know government shouldn't be doing any of that stuff. And if it didn't do any of that stuff it wouldn't need all of that tax money so that's the fundamental position and as long as you're going to have government do all that stuff you're going to have all those high taxes and I think that questioning doesn't happen [in the UK] *very much.*

Given that this view may not be held universally, we now consider the implications of such a loss in greater depth.

HOW TO MAKE GOOD THE DEFICIT AFTER INTRODUCING A FLAT TAX

There appears to be general agreement that a flat tax would reduce UK government revenue. Teather (2005) accepts this. So does Allister Heath, who in his proposal for a UK flat tax suggests the loss might be £59.7 billion (Heath 2006). In fact some, including Steve Forbes (2005: 4), suggest that this is a virtue of the flat tax.

That said, supporters of flat taxes argue that the cuts in government income will not be as large as the raw analysis (of the type used in this report) suggests. Allister Heath (2006) says: 'around 40% of the cuts in income tax, national insurance contributions and corporation tax will pay for themselves via stronger growth and less tax avoidance over three years'.

In so doing he matches the time period in which Teather (2005) suggests, more optimistically: 'that reducing taxes causes the economy to grow faster than it would otherwise, resulting in increased wealth for the population and (in time) increased tax revenues. As an estimate, this increased economic growth means that tax revenues will recover in just over three years'.

Speaking of these and similar assumptions, the UK Treasury comments (2005a): 'heroic assumptions are made about economic gains which trickle down through the economy'.

In fact, there is evidence of growth in states with both flat taxes and low taxes. Allister Heath (Heath 2006) states: 'In Russia, income tax revenues increased by 25.2% in real terms after it introduced its flat rate in 2001, by 24.6% in 2002, by 15.2% in 2003 and by 14.4% in 2004'.

It is, however, important to remember Ivanova et al's suggested reasons (2005) for this increase (see p. 30). They also note that the introduction of flat taxes was not the only change in the Russian economy during this period. As the Energy Information Administration (EIA) of the US Government has noted:

Buoyed by surging oil export revenues, Russia's real gross domestic product (GDP) grew 10% in 2000, with slower (but still strong) growth in 2001 (5.1%), in 2002 (4.7%), and in 2003 (7.3%). Russia's real GDP grew strongly again in 2004, at a 7.1% rate, with 5%–6% annual growth expected during 2005 and 2006. The oil export revenue windfall experienced by Russia since 2000 has helped the Russian government pay down some of its large foreign debt and to run significant budget and trade surpluses, with an estimated $88 billion merchandise trade surplus and a $60 billion current account surplus in 2004. (EIA 2005)

The same source notes that Russia's oil exports were forecast to grow from US$17.3 billion to US$111 billion at constant 2005 prices between 1998 and 2005. Quite clearly, this growth had a significant impact on taxation revenues.

In other countries where significant growth has been recorded caution is also needed. As Ivo Vanasaun of Estonia said when interviewed for this report: 'For example, comparing GDP, the bases of calculation are totally different now from 1991 or 1994'.

He also warned against over optimistic expectations about the effects of a flat tax system: 'I think it's too much to expect a flat tax to solve all problems, it's not true, it's a tax; it's not a medicine for the economy'.

Nonetheless, it is still useful to consider what growth might be required to recover lost tax revenues of around £40 billion if this sum were to be returned to the private economy. The sum of £40 billion has been tested on the assumption that other taxes are not abolished at the same time as flat taxes are introduced and other allowances and reliefs are not changed.

If growth were to be sufficient to restore the lost tax revenue (on the assumption that it was not considered desirable to cut government spending) then it would need to:

1. affect only the private sector, since the state sector will be constrained in its growth by a lack of income, and

2. yield tax revenues on only part of the growth, since a significant part of the benefit of the growth will, of course, be retained in the net earnings of those working to generate it.

The relevant multiplier might be about 2.7.[50] In that case the required growth might be about £108 billion to make good a revenue loss of £40 billion. At present, consumption expenditure amounts to about £753 billion per annum.[51] Since the state sector will be held constant, the consequent required growth in consumption is about 14.3%, if the lost government revenue is to be recovered from growth.

It is important to note that this growth in consumption would have to take place during a period when:

- the public sector would not grow, for the reasons noted
- there would be some economic disruption due to unemployment among staff previously engaged in the administration of taxation, since it is suggested that fewer staff will be required for this purpose (Hall and Rabushka 1995: 7–9)
- there will be a short-term government deficit (Teather 2005), which will absorb savings and therefore deny them for investment in the private sector
- the benefit of the tax cuts is uneven. The best off in society, who are the least likely to consume out of their marginal income, benefit most in absolute terms from the introduction of a flat tax and would therefore be expected to fuel growth to the greatest degree. As this group are, however, the most likely either to save their benefit or to use it to purchase residential property, their immediate consumption needs having already been met, this makes realisation of the growth objective more difficult, at least in the short term.

In that case the rate of growth required to restore equilibrium in government revenues is likely to be higher than that suggested above. This may explain why Heath (2006) does not suggest the shortfall would be made good, but suggests instead that savings in government spending will have to be made.

Nonetheless, the optimism of those who support flat taxes remains. For example, in interview, Richard Teather said: 'I think the main merit of [the flat tax] is its effect on people's activity'.

When asked how the 14% of the taxpayers who are currently higher rate taxpayers and who would be the main beneficiaries of a flat tax would change their activity and generate this growth he said:

They might be 14% of the taxpayers, but they are a large part of the economy and I haven't got the figures but I suspect they are a large part of the pool of investment capital.... Of course the outcome will depend on what people do and their willingness to invest in new businesses and the extent to which the tax system at the moment is stopping people from setting up new businesses.

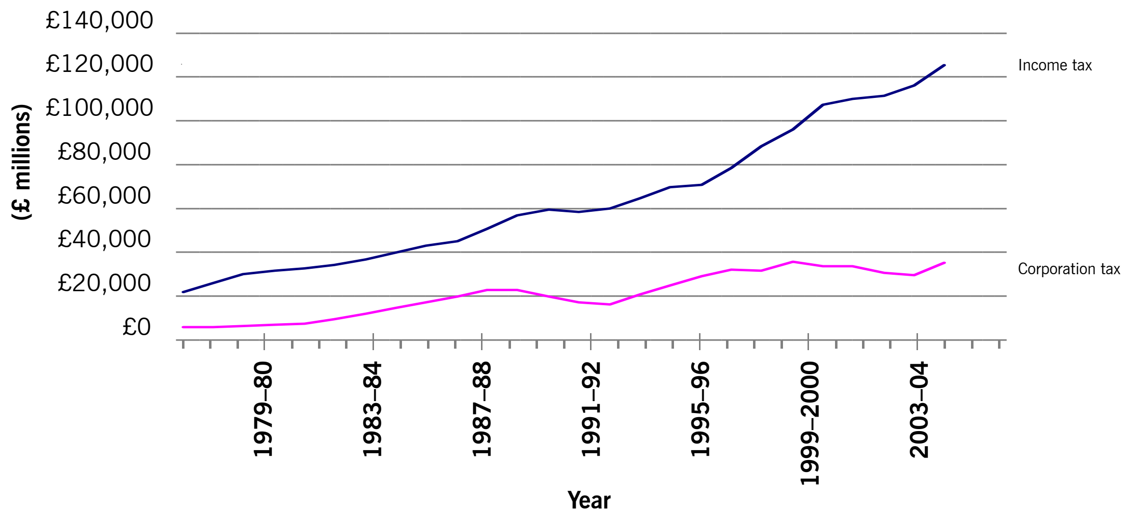
In other words, he sees an investment-driven and not a consumption-driven growth resulting from flat taxes. Crucially, he concluded his comment by saying: 'The pure answer is "we don't know", of course, because every tax reform comes with a different set of circumstances attached to it'.

He continued, picking up a theme also discussed by Steve Forbes (Forbes 2005: 122–8) that: 'We did have things like the '80s' booms after tax reductions then'.

[50] The multiplier reflects the ratio of 1/(proportional tax take). The proportional tax take has been assumed to be 90% of 41%, the latter being the proportion of GDP represented by government spending according to table B31 of the Pre-Budget Report, December 2005 (HM Treasury 2005b). The ratio of 90% reflects the fact that tax revenues would be cut by approximately 10% by the introduction of flat taxes.

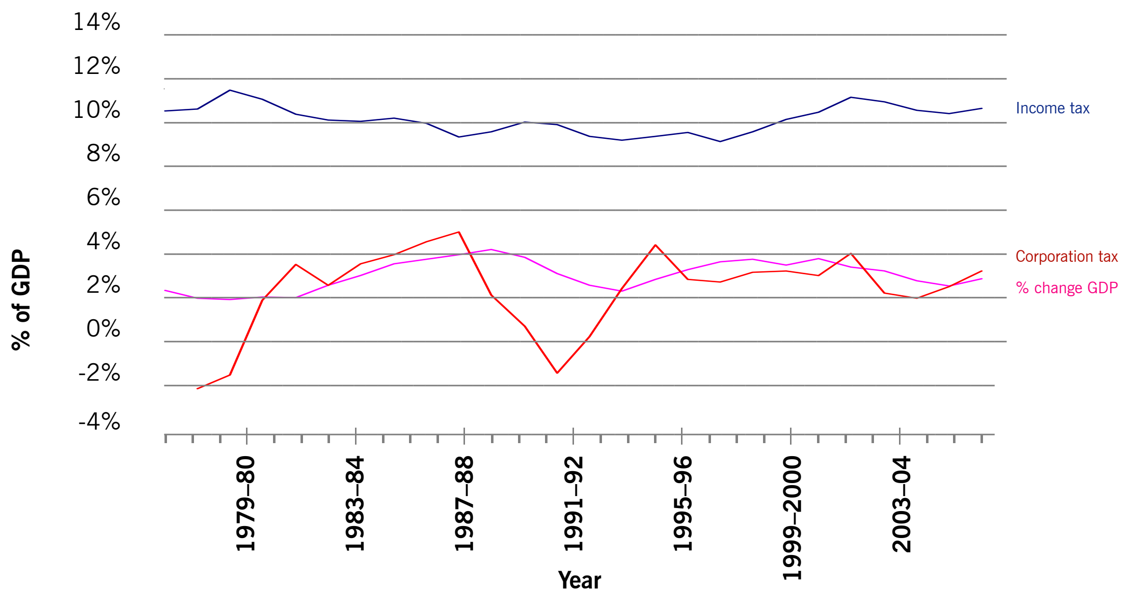
[51] National Statistics Monthly Digest of Statistics no 720, December 2005.

Figure 6.2: Taxation revenues by taxation type



Source: HMRC 1.2, 2005

Figure 6.3: Income and corporation taxes as a percentage of GDP



Source data: HMRC 1.2 (2005) and nominal (current value) GDP data and data on UK GDP at constant 2002 market price from Economic History Services <http://www.eh.net/hmit/ukgdp/>, accessed 20 February 2006.

This argument is often used, for example, by Grecu (2004). To use UK examples, it is suggested that when Nigel Lawson cut the top rate of personal income tax from 60% to 40% in 1988, it gave a significant boost to the economy, as had the earlier cuts in corporation tax from 52% to 35% over a period from 1983 to 1986. Figure 6.2 shows that during these periods there was a steady increase in tax paid but that the trend changed rapidly thereafter with corporation tax revenues falling from 1989 to 1994 and income tax revenues fairly static in the early 1990s (all figures expressed in the values of the period).

If these data are charted with the tax paid being shown as a percentage of GDP expressed in current value for the period, with changes in the real value of GDP (ie price adjusted) also shown, then real trends are more apparent, as in Figure 6.3.

Income tax revenue fell fairly steadily as a percentage of GDP from 1981–2 onwards, beginning to recover as a trend only from 1996–7 onwards. Corporation tax, however, was more volatile and displays a pattern markedly similar to changes in real GDP. The tax take for corporation tax compared with GDP did increase following the cuts in rates in the mid 1980s, but so did GDP itself and the fact that the same changes also saw the abolition of generally available first year capital allowances over the same years must also be taken into account.

Based on these reviews there is little evidence to prove that:

- tax cuts boosted real increases in tax revenues in the UK; income tax in 1988/9 (the first year of 40% top rates), for example, was 9.3% of GDP but 9.9% in 1987/8 (the last year of 60% rates) or

- tax cuts boost GDP; GDP growth fell rapidly from 1989/90, just two years after large cuts in income tax.

The data support the opinion of the UK Treasury: 'There is a serious lack of evidence that this [cost of introducing a flat tax] could be made up through improved compliance and economic activity, as is suggested by the proponents of flat tax' (HM Treasury 2005a).

There is also some evidence that cuts in taxation revenue have negative impacts on growth and that social inequalities might also be increased as a result. For example, McKinsey Global Institute (2003: 2), when reviewing the effectiveness of tax incentives in attracting foreign direct investment to intermediate developing countries, claim:

Popular incentives to foreign investment are not the primary drivers of multinational company investment and instead have negative and unintended consequences. Without materially affecting the volume of investment in most cases, popular incentives such as tax holidays...serve only to detract value from those investments that would likely be made in any case. Many of these policies result in direct fiscal and administrative costs, as well as indirect costs, particularly reduced productivity.

The McKinsey study did, admittedly, focus on developing countries but sought to explore more generally the idea that reducing tax rates attracts foreign investment. Hall and Rabushka (1995: 121) suggest: 'Foreign investment should pour into the United States after the flat tax is adopted'. Tax holidays, by exempting the income of companies investing in a foreign country, have much the same effect as the tax cut offered by flat taxes and are closely akin to the corporation tax of Estonia, which charges a flat tax only when profits are distributed. Yet the McKinsey Global Institute cannot find beneficial economic effects arising from such tax cuts. If that experience translated to the UK, Hall and Rabushka's flood of investment might not occur.

Robert Lynch has a different argument: 'An analysis of the relevant research literature, however, finds little grounds to support tax cuts and incentives – especially when they occur at the expense of public investment – as the best means to expand employment and spur growth' (Lynch 2004: vii).

He goes on to suggest that when considering location of businesses in the USA:

It is commonly thought that firms will migrate to a particular state for the purpose of reducing costs, since lower costs may result in higher profits for business owners. But state and local taxes are not typically a significant cost of doing business. All state and local taxes combined make up but a small share of business costs and reduce profits only to a limited extent. Indeed, the costs of taxes pale in comparison to many other location-specific costs, and numerous location factors – including qualified workers, proximity to customers, and quality public services – can be more critical than taxes. The availability of these vital location factors depends in large part on each state and locality's commitment to public investment – and their ability to pay for it. Research, in fact, substantiates that public investment plays a positive role in helping lower costs for firms.

This finding is supported by a comment from Ivo Vanasaun from the Ministry of Finance in Estonia. When discussing tax competition in the Baltic States, including Finland, he said: 'Our neighbour Finland had a [corporation] tax rate of 29% and now they have 26% and I am not sure whether they will reduce it again. But maybe they have better infrastructure – it also counts, it is not just a question of tax rate in tax competition in this region'.

Such a view might support Lynch's suggestion that:

Ultimately, the proof of the power of tax cuts and incentives to attract or retain business and create jobs lies in how firms respond to them. On this score, the evidence fails to support the claim that growing the economy requires shrinking the public sector and reducing taxes. In particular, there is little evidence that state and local tax cuts – when paid for by reducing public services – stimulate economic activity or create jobs. There is evidence, however, that increases in taxes, when used to expand the quantity and quality of public services, can promote economic development and employment growth (Lynch 2004: vii).

Contradicting Richard Teather's view that cutting tax rates stimulates investment (see p. 59) he concludes: 'The bottom line is that state and local taxes, at their current… levels, may be largely irrelevant to business investment decisions'.

If that is true then the expected growth in the economy may not happen, as Ivanova et al. (2005) also suggest.

As with so much in the flat tax debate, the issue comes down to one of belief rather than hard evidence. Alvin Rabushka's belief is clear. He said when interviewed:

Everything you're telling me that is a problem of the flat tax is a problem that's 2 to 10% of the current tax. Does it matter if there's still a problem with the flat tax? The problem is greatly relieved. You're not going to have perfect people and perfect government and perfect angels but we're going to get much closer to perfection. The main thing is we're going down the right road. Hall Rabushka is the path to perfection. It's not perfection itself but it takes you down that road whereas the current system is the road of good intentions paved to hell and that's what you've got – a living hell.

Belief does, however, need to be informed by clear thinking. It is to questions that might stimulate that thinking that this report now turns.

Section C: Flat tax and the UK – the implications of simplification

The flat tax debate in the UK has largely concentrated on:

- the reduction in tax rates
- tax simplification
- the incentives to work that lower taxes might provide
- the impact of flat taxes on government revenues.

These issues are important but as this report seeks to show, the impact of a flat tax in the UK would be much wider than this list would suggest. This section argues that the implications of a flat could extend to:

- other aspects of taxation
- the economy as a whole
- social policy
- the role of government in society
- international issues.

If the debate on flat taxes is to be meaningful an awareness of these broader issues is essential. Nonetheless, as is clear from much of this report, hard evidence of the impact of such a tax system is often hard to find. Consequently, this section does not present 'hard' evidence of what those implications might be but instead suggests possible consequences of the introduction of a flat tax under a wide range of headings. Where possible, those topics are illustrated either by reference to available literature or by quotations from experts from a wide variety of backgrounds and viewpoints, interviewed for this report.

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7. The role of the state and its government

THE ROLE OF THE STATE

Flat taxes raise questions about the future role of the state. For example, Hall and Rabushka (1995: 142–5) say a flat tax should not be charged on income arising abroad, but most states charge their citizens tax on all their income. A flat tax might therefore redefine the rights of the state in this area. This raises a range of issues, including the following.

- Should the state be able to charge tax on income that does not arise within it? If not, why not, especially if it has not been taxed elsewhere, as is common with much investment income?

- Should the state collect information on taxpayers that it might share with the taxation authorities of other countries? It does so at present, especially with regard to interest income, but if that income were not to be taxed, as flat tax theory suggests, it might not be able to do so in future. Is this important?

- What is the duty of the state to redistribute income? As this report shows, most commentators have found that flat taxes would increase the regressiveness of the tax systems of developed countries. Is this a matter of concern if the economies of those countries grew as a result, as those who support flat taxes think likely? Would the answer be different if they did not grow?

- At present the UK does not tax many state benefits it pays to those in need, and provides additional tax relief to the elderly. This is part of a policy to redistribute wealth. Richard Teather proposed the abolition of those reliefs in his paper for the Adam Smith Institute (Teather 2005). Is that reasonable?

- Professor Joel Slemrod, Professor of Economics at the University of Michigan, suggested in the Institute for Fiscal Studies annual lecture on 26 September 2005 that those who propose flat taxes do so because they like small government. Those who like small government do not want governments to hold more information on individuals than is strictly necessary. Progressive taxation requires quite a lot of information about an individual's income and personal circumstances; flat taxes do not, hence the proposal from Steve Forbes (2005) that a flat tax return could be done on a postcard. Is it reasonable for governments to hold information on individuals? How much should they have? Is it appropriate for the state to make intrusive enquires of the individual in pursuit of its taxation policies? Are those who believe flat taxes are part of small government making a case which has popular support?

THE ROLE OF GOVERNMENT

It has been suggested, for example by Mitja Èok of the University of Ljubljana, that governments who adopt flat taxes and who have also passed control of their monetary policy to central banks (as is the case with regard to monetary policy in the UK) have no levers for control of their economic affairs left because the normal mechanisms of control have been fiscal measures or interest rate policies (Èok 2006). Current political pressures on governments suggest that a flat tax government might find itself virtually unable to increase the tax rate or reduce allowances, as appears to have been the experience of the UK government over the last 15 years or so. This might leave it with little or no control over its revenues or the economy. In that case the following questions arise.

- Do we expect governments to intervene to manage the economy, or are we happy to allow market forces to prevail?

- Do we expect elected politicians to make choices about taxation, or do we want to curtail their activity in that area?

- If we limit the power of politicians to intervene to raise the revenues they require how do we expect them to manage the state budget with reasonable expectation that it will balance?

- What else might be forgone if politicians do not intervene in the economy? Would the credibility of government itself be increased or reduced in that case, and which might be better?

THE PROTECTION OF REVENUE

There is a widespread desire for simplification of the taxation system, but as the example given on the States of Jersey has shown (see p. 35), even tax codes that can fairly be described as simple[52] require significant anti-avoidance provisions. In Jersey this includes a general anti-avoidance provision. This is, however, credited with preventing the system from developing into the 'nine-headed Hydra that is UK anti-avoidance law'.[53] Jersey does not have a pure flat tax but is closer than some systems since it does not have a capital gains tax or inheritance tax, has low rates of income tax, limited social security charges and exempts overseas income for many corporations. Its approach to anti-avoidance legislation has been very different from the UK's, but as it is now moving towards even lower rates of tax in some areas its anti-avoidance procedures may be tightened.

- Does this suggest that the UK would need to reconsider its approach to avoidance if it had a flat tax?

- Does it suggest that a general anti-avoidance provision might be needed, as it is in Jersey, even though opponents of such provisions have suggested they can be arbitrary in operation?

[52] For example, Jane Stubbs, a partner in PricewaterhouseCoopers Jersey described the Jersey tax code as a 'simple yet effective law' at <http://www.thisisjersey.com/businessreview/showbusinessreview.pl?ArticleID=000024>, accessed February 2006.

[53] Ibid.

- Would such anti-avoidance provisions make the UK a more or less attractive place in which to site a business?

- Might a Hall and Rabushka type flat tax not be possible because exempting foreign income could create too many loopholes of the sort currently used by those not domiciled in the UK?

THE TAXATION OF CONSUMPTION

Flat tax theory suggests consumption and not income should be taxed. The effect is that labour is taxed, as is business, on a cash flow basis, but with no second charge to tax when business income is paid to its owners. In Estonia this is taken to its logical conclusion, as companies are taxed only when they distribute profit to their members. No other country has gone as far. Those other flat tax states do instead have what might more fairly be called 'single rate income taxes'. They continue to charge all income to tax, but at one rate. This means that if it were to have a flat tax the UK would have to make some big decisions on issues such as the following.

- Should all income be taxed, including that from overseas and that from savings?

- Should companies be taxed on their profits?

- How should double taxation of corporate profits be avoided? Would this be by continued use of the imputation system, which the UK has used in various forms since the 1970s, or by use of the system pioneered by Estonia and the additional model suggested by Hall and Rabushka, where business gets no relief for interest paid, but savings income is free of tax?

- Would stopping the taxation of investment income shift the benefit of flat taxes too much towards the better-off, who enjoy most of that income?

8. Flat tax and simplification

HOW IMPORTANT IS SIMPLIFICATION?

One of the greatest motivations for flat tax is a desire for simplification of the tax system. This is, according to Hall and Rabushka (1995) and Forbes (2005), one of its main advantages. In interview, Richard Teather disagreed. He said

I think the main merit [of a flat tax] *is its effect on people's activity; that moving from a system of 40% tax for the better off with various tax breaks down to a system with a lower rate, whatever that is, without the incentives will mean people will not have to worry to the same extent about the impact of taxes so you get a neutrality from the investor's point of view but you also have neutrality from the government's point of view, so you stop getting a different set of incentives to follow every two or three years.*

This is reflected in his design for a flat tax for the UK, which he confirmed during interview assumed that an accounts basis was used for the assessment of business profits, which is far removed from the cash flow basis that Hall and Rabushka (1995) proposed. He also eliminated only some reliefs, such as those on ISAs and other savings, age-related allowances, those that exempted state benefits from tax and capital gains tax taper relief (which would mean an effective increase in the capital gains tax rate in most circumstances since he retains the tax in his system). He also proposes abolishing some minor reliefs such as those for professional subscriptions, research and development, rent-a-room and termination payments. Despite this, he predicts a loss of at least £35 billion in government revenue.

Howard Reed of IPPR suggested a quite different approach when interviewed, considering that simplification could come only from a merger of the tax and national insurance systems. Allister Heath (2006) agrees with him, despite coming from a different part of the political spectrum.

A range of questions might be asked on these issues.

- Can an accounts basis be adopted for the taxation of business?
- Will this provide fair relief for capital expenditure, or should enhanced capital allowances be available?
- Why should some reliefs be abolished (especially those on the elderly and those on benefits, who are likely to be lower paid) when relief for pension contributions, which has a much higher cost at £13.7 billion a year, would continue?
- Should the tax and national insurance systems be merged? If so, how are the elderly (who do not pay national insurance) to be protected from an additional burden?

TAX ADMINISTRATION

Tax simplification has to be matched by changes in tax administration if the benefits are to be seen. In the UK only 16% of people submit tax returns. In the US it is 44%. In Estonia, where tax is deducted at source but without anything but a basic personal allowance being taken into account, 84% of taxpayers submit a tax return.[54] As noted previously (see p. 18), Alvin Rabushka says he would like all people to be required to submit a tax return just so that they are aware of the tax that they pay. As can be seen, administrative burdens vary, and perceptions of their importance do likewise.

Not all administrative burdens are simplified under flat tax systems. Estonia requires submission of monthly returns of income tax, social security taxes, tax due on

[54] Information supplied by Ivo Vanasaun, Head of Direct Taxes Division, Estonian Ministry of Finance, during an interview undertaken for the purposes of this report, 16 February 2006.

[55] Ibid.

benefits in kind and tax due on dividends paid.[55] The reporting obligation with regard to the last two items is more frequent than in the UK. In addition, the need to identify expenses incurred by the business for the benefit of employees is identical to the current requirement to declare those same expenses as a benefit in kind for employees and as such there would be no administrative saving in this area in the UK. Elsewhere, in other tax systems and as noted above (see p. 24 for example), rules for accounting for some expenses and for capital expenditure appear more complex than those in the UK despite the operation of single rate taxes.

This gives rise to a range of questions.

- Would UK taxpayers be happy with a flat tax system if it meant more people had to file tax returns, as appears commonplace elsewhere?

- Would the administrative burdens on companies be significantly eased if the existing rules with regard to disallowable expenses, benefits in kind and accounting for capital expenditure continued in operation?

- Are there ways of achieving reduced administrative burdens other than by the introduction of single-rate flat taxes?

- If simplification is achieved at the expense of tax reliefs on pensions, capital gains tax taper relief (including on the sale of businesses), charitable donations, the promotion of new enterprise through venture capital trusts and share incentive schemes, what are the likely implications for long-term saving, entrepreneurship, the charity sector and capital investment?

- If more tax returns must be submitted, what chance is there that the government's cost of administering the tax system will be reduced?

THE TRANSITION TO FLAT TAX

As Teather (2005) and Heath (2006) have both suggested, there will be a significant cost to the UK if a flat tax is introduced. Government borrowing will rise for at least three years, and by up to £50 billion a year. Total government borrowing is now £440 billion (HM Treasury 2005b). The cost of introducing a flat tax is, therefore substantial. This raises the following questions.

- Does the UK economy have the capacity to lend the government the cash to finance the introduction of a flat tax without significant problems arising?

- Does UK business have the capacity to handle the change to a flat tax? Do UK taxation professionals have the capacity to handle the changes that would result? Is there a risk of chaos?

- Could the introduction of a flat tax provide an opportunity for tax abuse as the basis of taxation changed from one system to another? Would this be harmful in itself?

DEFINING THE TAX BASE

Many of the problems in the tax system have one of two causes. The first is in deciding what something really is for tax purposes; the second is in deciding who should pay tax on it. So, for example, in the well-known Artic Systems case[56] the issues in question are whether the income being considered is a dividend or should be a salary, and whether it is all taxable on the husband who part-owns the company in question or whether it may be shared with his co-owner, who is his wife.

[56] For more information see <http://uk.accaglobal.com/uk/members/technical/comment/660>.

These problems continue in flat tax states. Ivo Vanasaun from the Estonian Ministry of Finance confirmed when interviewed that the same problems happen in his country: ‘Our social tax rate is really high; it's 33% and paid by the employer. The owner of a small company who at the same time works there, they prefer to have dividend income for example instead of wages to avoid social security. This problem is still there’.

And he went on: ‘It is really complicated to tackle this issue because it is a question of how to divide the income between capital income and employment income so there is no good answer in place actually. In some cases the tax commissioner can prove it, in some other cases they can't’.

The story sounds remarkably similar to the situation in the UK, although he added: ‘But we don't have problems about whether something is capital gains or income, for example, because the tax rate is the same so it is much easier’.

This poses a range of questions.

- Can flat taxes simplify taxation when social security charges continue at quite high rates?

- Is it reasonable to stop the capital gains/income definition problem by simply taxing all capital gains as income, with no allowance being given for capital gains (as is the case in Estonia[57]), or will this bring a significant number of additional transactions within the scope to tax with a much increased burden of tax administration as a result?

- Will offshore problems always exist in any tax system and require special legislation to deal with them, as both Estonia and Jersey have found?

[57] Information provided by Ivo Vanasaun in conversation 16 February 2006.

- Is it possible to create a tax system (flat or otherwise) where these problems do not exist or should we accept that Ivo Vanasaun was right when he said that: ‘There are no tax systems without problems. You cannot have tax systems purely decided upon by people from tax policy departments. Politicians create tax incentives that are not necessary from the tax point of view’?

INTERNATIONAL OBLIGATIONS

Most countries, including the UK, have many international double tax treaties and other related obligations. The American Institute of Certified Public Accountants has pointed out that a flat tax may be considered a ‘subtraction method VAT’, which means it may not be acceptable under the terms of the General Agreement on Tariffs and Trade (AICPA 2005). This raises questions.

- To what extent should any tax reform be designed to meet international obligations rather than the needs of the domestic market?

- How would a flat tax affect the UK's relationships with the EU?

SMALL BUSINESS

It has been the practice of the UK to tax smaller business at lower rates than large business, the current differential being 11% between the main corporation tax rate of 30% and the small company rate of 19%. Flat tax theory says there should be one tax rate. Richard Teather (2005) suggests a flat tax rate of 22% for the UK, although allowing that the rate need not apply to companies. If it were to be applied to them, however, a rate of 22% would be an increase in the tax burden for small business in the UK but would represent a reduction in the burden for many large companies. This raises the following questions.

- Should small business be treated differently from large business?

- Should that difference be expressed by a lower tax rate?

- Should small businesses be preferred in other ways, eg by simpler accounting rules (some countries, such as Romania allow small businesses to account on a cash flow basis, for example)?

- Should very small businesses be offered different advantages, eg by being allowed to claim standard percentage cost allowances against turnover, depending upon the type of business, instead of having to prepare full accounts with all expenditure being detailed? This is, for example, allowed in Slovakia, and is allowed, in a not dissimilar fashion, for UK flat-rate VAT schemes.

- If one tax rate were to be used would this shift the balance of advantage within the economy towards big business?

- Would there be less incentive for small business to incorporate if there was just one flat tax rate for companies and individuals, so largely avoiding this problem?

9. Other consequences of a flat tax

INCOME DISTRIBUTION

Data on the impact of flat taxes produced for this report suggest that the poor benefit to a limited extent from flat taxes, those who are best off in society benefit most and that those on what are considered to be middle-income ranges are likely to pay more tax. The same conclusions have been reached in the Netherlands and Denmark (Heineken 2006; Larsen 2006). If this were the case, the following questions would arise.

- Would a flat tax be politically acceptable to the majority of voters?
- Would the implied redistribution of income away from middle-income earners benefit the economy?
- Would there be social consequences arising from this change?

TRUSTS

Trusts are a feature of Common Law and are not found in most countries that are considered to have flat taxes. They have traditionally played a significant part in tax planning in the UK.

- Would trusts continue to play this role under a flat tax system?
- Would trusts be subject to flat taxes?
- Would trusts be able to enjoy the benefit of any allowances?
- Are trusts unnecessary complications in a flat tax system?

RESIDENCE AND DOMICILE

The UK has complicated rules on both residence and domicile, the latter being relatively unusual. None of the countries discussed in this report that have flat taxes has a similar concept in their taxation law. Instead they have concepts of residence that mean that all residents pay tax on their worldwide income. This raises important questions for the UK.

- The UK has retained its domicile system as it believes it provides it with a competitive advantage. Would this advantage be lost under a flat tax system?
- Would the concept of 'ordinary residence' need to be retained under a flat tax system?
- Can a flat-tax system help tackle the problems of defining the source of an income stream and therefore help determine how it might be taxed?
- What anti-avoidance arrangements would need to remain under a flat tax system to prevent those resident in the UK diverting their income offshore? Estonia found it necessary to introduce significant anti-avoidance laws for both individuals and companies to tackle this problem.[58] Would we have to do likewise?

NATIONAL INSURANCE

As already noted (see Table 3.3, p. 26), most flat tax states require that employers and employees in combination pay much higher rates of social security or national insurance taxation than is commonplace in the UK. This raises serious issues for the UK.

[58] Information provided by Ivo Vanasaun in conversation 16 February 2006.

- If a government in the UK sought to recover tax lost from introducing a flat tax by imposing higher national insurance charges what would the implications be?

- Are national insurance charges a tax on earned income in anything but name?

- Is it reasonable to tax earned income more than other sources of income if national insurance charges are considered to be tax?

- Would this trend be exacerbated under a flat tax, especially if investment income were not taxed?

- Will significant differences between a flat tax rate and national insurance rates, where the latter are applicable only to earned and not investment income, require any government to continue to tackle tax planning of the sort addressed by IR35 and which comments from Estonia (see p. 68) suggest to be of concern there?

- If national insurance remains at current levels, will employment really be encouraged by an increase in the personal allowance under a flat tax scheme, given that national insurance charges will still have to be deducted, administrative burdens will be little reduced and the employer's contribution to national insurance will, presumably, continue?

CAPITAL GAINS

Hall and Rabushka (1995) and Forbes (2005) say capital gains taxes should be abolished under a flat tax system. In interview, Richard Teather did not agree. He said: 'I wouldn't abolish capital gains tax. I think you should only abolish capital gains tax if you are also abolishing tax on investment income; I think the arguments for the two go together'.

He had previously agreed he would not abolish tax on investment income, saying: 'I can see the economic argument for it; I think I would find it very difficult to argue for it from a political point of view'.

For that reason he thought it should be retained. But, in his paper (Teather 2005) he argues for the abolition of taper reliefs and allowances, so effectively taxing capital gains at rates much closer to income. These suggestions raise the following questions.

- Should capital gains be taxed?

- If not, are tax avoidance measures needed, as in Jersey, to prevent the recategorisation of income as gains?

- Should capital gains be taxed as income, as they are, for example, in Estonia, with no allowances being given? What impact would this have on the small stock market investor, for example?

- Should taper relief be abolished? Is it an onerous burden to calculate, or is it an artificial reduction of a tax rate?

- If all gains are subject to tax at income tax rates would this be a disincentive to the owners of small businesses, who may seek much of their eventual reward on the sale of their business?

- Income has often been converted into gains through the use of investment vehicles such as roll-up funds, often located offshore. Would measures be needed to prevent this action if capital gains were abolished or should such planning be allowed?

INHERITANCE TAX

Inheritance tax appears to be very unpopular in the UK. National newspapers have run campaigns to abolish it.[59] Part of the reason for charging inheritance tax is that capital gains tax is not charged on death. In that case, if capital gains tax is to be retained, the following questions should be addressed.

- Should capital gains tax be charged on death and inheritance tax be abolished?
- Should death be an event that triggers any tax charge?
- Should capital gains tax be reduced in old age to stop people holding on to assets unnecessarily to prevent a capital gains tax charge arising on them if inheritance tax is abolished?
- Should capital gains tax be abolished along with inheritance tax?
- How valid are other factors, such as the redistribution of income, which suggest inheritance tax should be retained, but reformed to meet popular criticism?

CHOICE OF TRADING MEDIA

The UK allows small businesses to trade as sole proprietors, partnerships, limited liability partnerships and limited companies. The first three are subject to income tax rules and the last to corporation tax. In Slovakia the income tax and corporation tax rates are the same. This is unusual. In the Baltic States corporation tax rates are lower than personal tax rates; in the countries that have more recently adopted flat taxes corporation tax rates tend to exceed personal income tax rates. These differentials have always affected the choice of trading media, as the impact of the short lived 0% corporation tax rate for small companies in the UK showed. This suggests that it is appropriate to ask the following questions.

- Should tax be a significant factor in the choice of trading media?
- Should the same rate be applied to limited companies and income tax to prevent this?
- If rates have to be different, who should have the lower rate, companies or individuals?
- If the rates are different, should the choice of medium be considered a tax-avoidance exercise subject to anti-avoidance rules, or is it legitimate commercial activity, given the incentives provided?

TAXATION OF THE FAMILY

Hall and Rabushka (1995: 59) suggest additional allowances for family members and personal allowances transferable between spouses. These are features of the tax system not seen in the UK for well over a decade. The following questions arise.

- In a tax system designed to minimise incentives and allowances, should the family get special deductions?
- Should taxation be used as part of social policy in this way? If it should, should it be used for other elements of social policy, eg income redistribution, or to support the elderly?
- Should children provide tax relief to their parents or simply enjoy an allowance in their own right, subject to their having their own income?

[59] For example, the Daily Express in 2006.

ANTI-AVOIDANCE MEASURES

It has been suggested (see Chapter 4) that the amount of tax legislation, which is a cause of much criticism, results from extensive anti-avoidance legislation. Some aspects of this issue have been discussed (see p. 34), but the following additional questions arise.

- Would a general anti-avoidance provision, such as that used by Estonia[60] make it easier to understand taxation law?
- Would such a provision encourage compliance with the law, as Ivo Vanasaun of Estonia suggests?
- The countries that have flat tax systems are steadily introducing transfer pricing rules, perhaps as they become more experienced with the abuse that such systems can create. Would such rules be required in a UK flat tax scheme?
- Estonia has rules to prevent the deduction of expenses incurred other than for business purposes (the example used by Ivo Vanasaun when interviewed was of a yacht claimed as a business deduction by a farmer). Will rules on what is allowable and non-allowable expenditure be required in a flat-tax system in the UK and what audit arrangements would be needed to ensure that they were complied with? What penalty arrangements might be in force if they were not?

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[60] Estonia's general anti-avoidance provision is section 84 of the Taxation Act passed 20 February 2002 and reads '§ 84. Transactions and acts performed for purposes of tax evasion – If it is evident from the content of a transaction or act that the transaction or act is performed for the purposes of tax evasion, conditions which correspond to the actual economic content of the transaction or act apply upon taxation'. In effect, this provision says that the economic substance of a transaction will be taxed, and not its legal form. In general this is contrary to English law. The provision is supported by section 83 (4) of the Act, which says: 'Fictitious transactions shall not be taken into account upon taxation. If a fictitious transaction is entered into in order to conceal another transaction, provisions concerning the concealed transaction apply upon taxation'.

10. Flat tax rates

Perhaps the most difficult choice under a flat tax system is the rate to be used. As the UK Treasury said (HM Treasury 2005a): 'with only two levers [the rate of taxation and the personal allowance on personal incomes] to determine the government's tax revenue, it is critical to the success of the structure that these levers should be set correctly'.

As noted in Chapter 4, Robert E. Hall thinks that the 'safe zone' for a tax rate is below 30% (Hall 2004: 2). He argues: 'Experience everywhere in the world at all times has taught that tax rates above about 30 percent generate inefficiencies that far outweigh the limited revenue that they collect'.

Not everyone agrees with him. In interview,Richard Teather summarised what he thinks is the view of many who set up in business.

Most people think that if I make any money out of this, 40% will be going off to Gordon Brown. There might be ways of getting round this but these are something I do not understand, these are outside my knowledge and I can get someone to sort this out but that will cost me money and then I am doing what someone else is telling me to do rather than running my own business and that may in some cases be incorrect but with the clients I have worked for that's how they think it is.

He argues that even if they are wrong it is worth reducing tax rates from 40% because impressions affect behaviour.

Ivo Vanasaun agrees. He said when interviewed:

I agree with Mr Rabushka as far as I understand him. Somehow it's the way of thinking, and not just having a flat rate of tax. It's also a question of reducing or controlling government expenses and the idea of having a simpler system.

These views suggest that there are a range of conflicting objectives in setting a flat tax rate. A Treasury might be seeking to raise revenue; others might have more subjective viewpoints. The range of rates in operation (from 12% in Georgia to 33% in Lithuania) suggests that many options are available. The following questions arise.

- Should the choice of flat tax rate ensure all UK income taxpayers, except those on the 10% rate, have their marginal tax rate cut (suggesting a rate of less than 22%)?
- What risks are there if the flat tax rate is higher than the existing basic rate of 22%?
- Would flat tax be perceived to be a benefit by most people if it was set at the existing basic rate of 22%?
- If a flat tax could not raise sufficient revenue to meet current spending levels, what should happen? Should government spending be cut or should other taxes be increased?
- If national insurance was increased to compensate for a budget deficit (along the lines seen in Eastern Europe where equivalent rates are higher than in the UK) would flat tax be seen as being effective?
- If the government's budget were to be cut, what activities or services should be cut?
- Should a flat tax rate be the same for corporation tax and VAT, as is the case in Slovakia?
- Should the same flat rate also be extended to capital gains tax, as is common in many Eastern European countries?
- Do similar rates solve tax problems, as some quoted in this report suggest?

WHY ONLY ONE TAX RATE?

'Flat tax' is a slogan. As this report has shown, the theory of flat taxes and the taxes that are in operation that are described by that name are quite dissimilar. Flat taxes are consumption taxes that are, in effect, value added taxes (VATs). That is their appeal in the US, which does not have such a tax. In Europe, where there are VATs in universal operation, taxes that might more accurately be described as single rate income taxes have been adopted under the banner of 'flat taxes'.

There remains an important question. Why is one rate of tax a necessary part of a flat tax system? Perhaps the question would not be asked here except for the fact that Robert E. Hall, one of the founders of flat tax theory, now seems to doubt that one tax rate is necessary. In testimony to the US House of Representatives on October 2004 about what he now calls the 'American VAT', which is his version of the flat tax, he said: 'In the American VAT, families would continue to fill out a personal tax form, but it would be simple enough to fit on a postcard. Only earnings are taxed on the form. The personal tax has a generous exemption and could have a couple of rates, say 15 and 25 percent.' (Hall 2004: 3)

As the comparison of tax systems in Eastern Europe in this report shows, while many have one dominant tax rate, several rates of both income tax and corporation tax are common. Hall's suggestion seems to fit into this model and suggests multiple rates may be acceptable.

For many, but not all promoters of flat tax, simplification is the aim. Others, such as Professor Mike McIntyre, suggested when interviewed that there are other reasons for choosing tax rates, such as a desire for redistribution of income.

In that case some final questions have to be asked.

- Does tax simplification require a single rate of tax?
- Instead of introducing one tax rate, could the tax budget be better spent in simplifying other areas of the tax system or in pursuing other goals?

Appendix 1: The interviewees

The following people were interviewed for the purposes of this report.

Professor Alvin Rabushka

Alvin Rabushka, the David and Joan Traitel Senior Fellow at the Hoover Institution, Stanford University, works in the public policy areas of taxation in the US and abroad, economic development in the Pacific Rim countries, and the economies of Central and Eastern Europe.

His books and articles on the flat tax (with Robert E. Hall) provided the intellectual foundation for numerous flat tax bills that were introduced in Congress during the 1980s and 1990s and for the proposals of several presidential candidates in 1996 and 2000. He was recognised in *Money* magazine's twentieth-anniversary issue 'Money Hall of Fame' for the importance of his flat tax proposal in bringing about passage of the Tax Reform Act of 1986.

Professor Mike Mcintyre

Professor McIntyre has written widely on a variety of tax topics, including the taxation of the family, the proper tax treatment of interest payments, and the international aspects of taxation. Before coming to Wayne State, Professor McIntyre practised with a tax firm in Washington, DC, and served for four years as the director of training at the International Tax Program of Harvard Law School. He was the founding editor-in-chief (1989–91) of *Tax Notes International,* the leading journal dealing with international tax issues.

Also in the international arena, Professor McIntyre has served as a consultant to national governments on six continents, to the United Nations Department of Economic and Social Affairs, and to the Organization for Economic Cooperation and Development (OECD). He has served as a consultant to the United Nation's Committee of Experts on International Cooperation in Tax Matters, a group that has prepared and updated the UN's model tax treaty.

Howard Reed

Research Director of the Institute for Public Policy Research (IPPR). Before joining IPPR, Howard was Programme Director for Work and Income Research at the Institute for Fiscal Studies between 2001 and 2004. He had worked as a Research Economist at the Institute for Fiscal Studies between 1995 and 2001. His research interests include labour market policy, taxes, benefits, tax credits, inequality in the UK, education and training policy, microeconometric analysis and programme evaluation. He directed IPPR's research into flat tax issues.

Richard Teather

Richard Teather BA (Oxon) ACA is a UK chartered accountant and Associate Senior Lecturer in Tax Law at Bournemouth University, and is also a freelance consultant and writer on tax issues. Earlier in his career, he worked in the City as a tax adviser. He has written on flat taxes for the Adam Smith Institute and on tax competition for the Institute of Economic Affairs.

Ivo Vanasaun

Ivo Vanasaun is Head of the Division of Direct Taxes in the Tax Policy Department of the Estonian Ministry of Finance.

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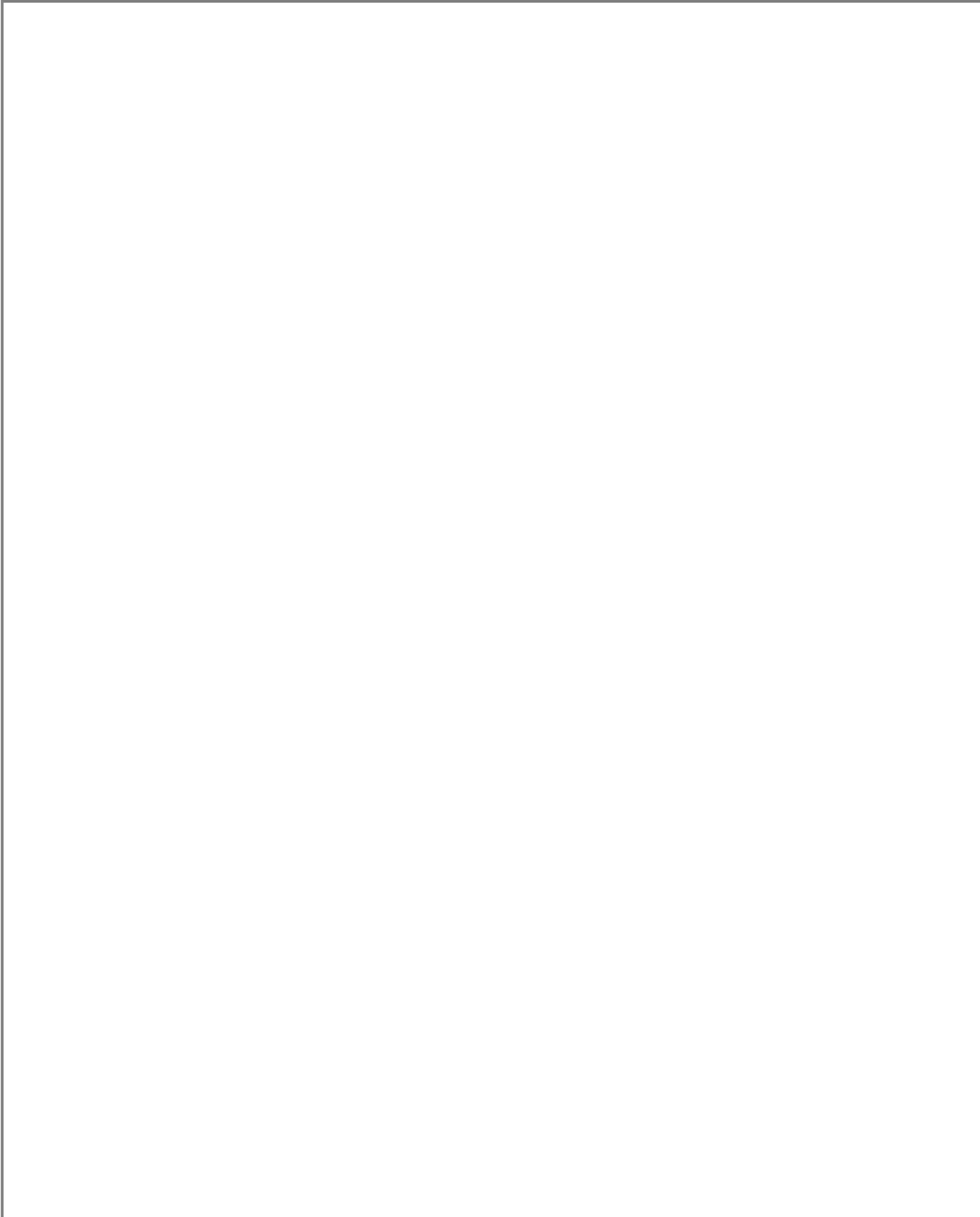

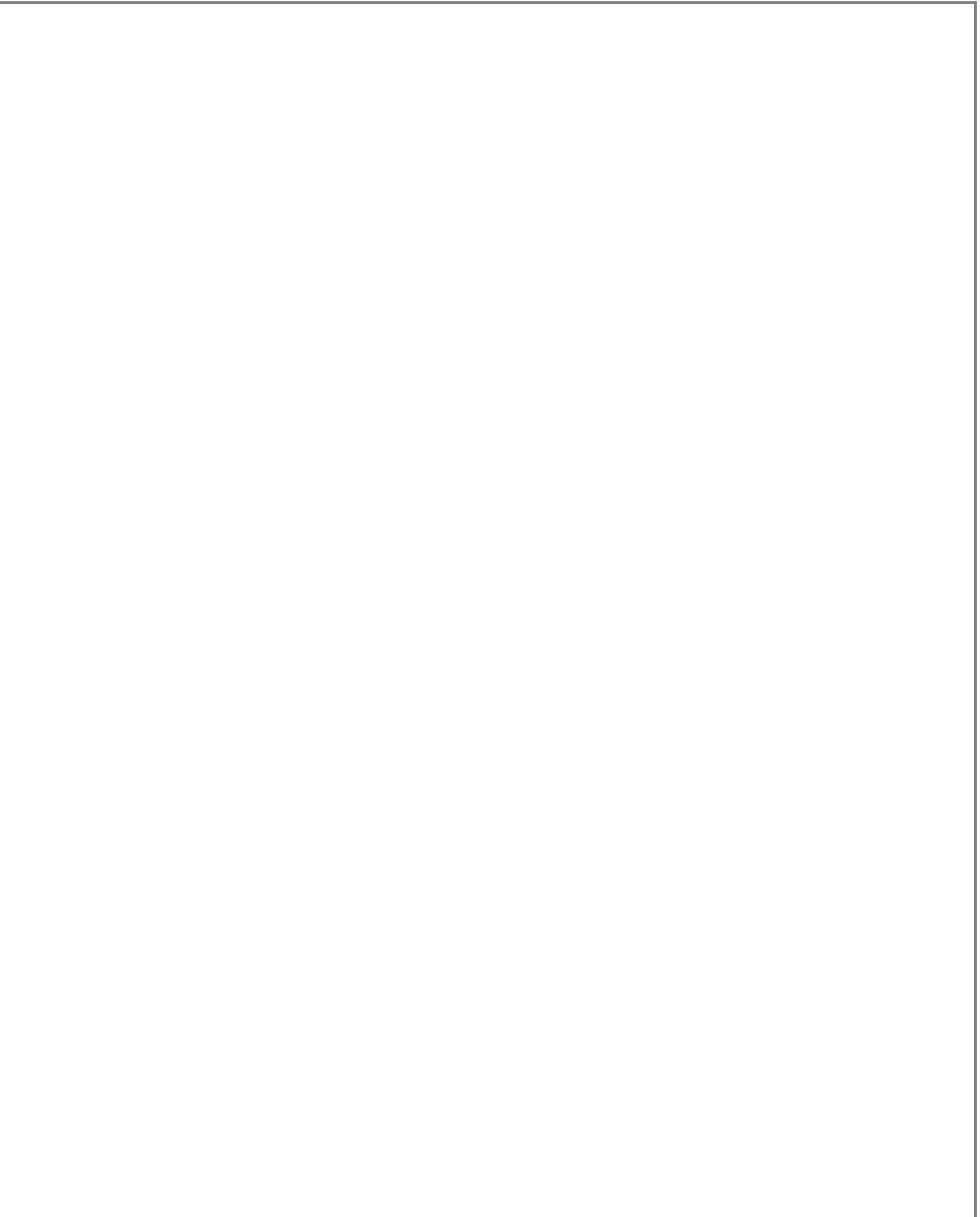

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