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Effects of flat tax reforms in Western Europe

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Abstract

Recent success of the flat income tax in Eastern Europe raises questions about whether there is scope for such a policy reform in Western Europe as well. We address this by estimating the potential distributional impact of various flat taxes for selected Western European countries. Our simulations show that in specific circumstances a revenue neutral flat tax reform can increase income equality and improve work incentives; however, in most cases there is an equity-efficiency trade-off. We show that the specific flat tax design and the welfare state regime play a key role.

JEL classification: C81; D31; H24

Keywords: Flat tax reform; Income inequality; Labour supply incentives; Microsimulation

1. Introduction

One of the most striking economic policy developments of recent years has been the large number of countries adopting a flat income tax, i.e. broadly speaking a tax with a single positive marginal rate (with or without a tax-free threshold). Although the seminal proposal by Hall and Rabushka (1983, 1985) triggered a lively academic and political debate, before the mid-1990s only a few countries and territories had actually implemented a flat tax, most prominently Hong Kong and the Channel Islands. Since 1994, however, after its introduction in Estonia, many countries have followed suit. At the beginning of 2009, there were nearly thirty countries worldwide with flat tax systems, about half of which were situated in Eastern Europe. Whilst the implementation

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of such reforms is currently under discussion in several other countries, including many in Western Europe (see, e.g., Keen, Kim, & Varsano, 2008, and Nicodeme, 2007), Iceland has been the only country in the region to adopt a flat tax. Considering the recent success of the flat tax in Eastern Europe, questions arise about whether there is scope for such a policy reform in Western Europe as well.

Potential gains associated with the flat tax include the simplification of tax filing, with proponents dreaming of a tax return fitting on a postcard (Hall & Rabushka, 1985) or a beer coaster (Kirchhof, 2003), which may well lower the costs of tax compliance and administration. Also, flat taxes are believed to improve labour supply incentives and reduce tax evasion. The argument for improved compliance is perhaps weaker in developed countries, but it is often central to this kind of reform in developing and transition countries. These arguments point towards possible efficiency gains and potentially higher tax revenues and social welfare. On the other hand, the impact of flat taxes on the distribution of the tax burden may represent a serious drawback and could be the main reason limiting their spread in developed countries with a well established middle class.

However, in the discussion of the flat tax "a notable and troubling feature [. . .] is that it has been marked more by rhetoric and assertion than by analysis and evidence" (Keen et al., 2008, p. 713). For instance, only a few empirical studies have considered previous reforms in detail. The most attention has been paid to the Russian flat tax reform of 2001 and there is some evidence that it was associated with increased (voluntary) compliance (Gorodnichenko, Martinez-Vazquez, & Peter, 2007). It was also followed by significant real growth in personal income tax revenue, but there was no strong evidence that this was caused by the reform itself or by improved law enforcement, nor could any positive labour supply responses be identified (Ivanova, Keen, & Klemm, 2005). In another example, the 2004 reform in Slovakia, income tax revenues declined, however, in the longer term the reform is expected to bring efficiency gains (Brook & Leibfritz, 2005; Moore, 2005). Furthermore, Saavedra, Marcincin, and Valacy (2007) make a general claim on the basis of cross-country regression models that the flat tax reforms on average affect compliance positively but do not have a significant impact on revenues.

Given that flat taxes have not yet been implemented in Western countries, the potential effects of flat tax reforms in these countries have mainly been studied using simulation models. There have been several previous studies, usually focusing on a single country (see, e.g., Aaberge, Colombino, & Strøm, 2000; Adam & Browne, 2006; Caminada & Goudswaard, 2001; González-Torrabadella & Pijoan-Mas, 2006; Kuismanen, 2000). Overall findings indicate that introducing a flat tax would redistribute in favour of high income households and enhance labour supply (incentives). However, we argue that this could be the outcome of specific parametric reforms rather than a universal feature of the flat tax. This is supported by the findings of Fuest, Peichl, and Schaefer (2008) for Germany and Jacobs, de Mooij, and Folmer (2007) for the Netherlands which show that a flat tax with a high basic allowance and a high rate has less harmful distributional effects than a flat tax with a low rate. However, only the low flat rate led to positive, albeit small, labour supply effects.

The aim of this paper is to analyse the feasibility of the flat tax policy option for Western Europe, focusing on the distributional aspects which are likely to be more important than in Eastern Europe. We contribute to the existing empirical literature on flat tax reforms in two ways: first, by addressing explicitly the parameterisation of flat tax reforms, and second, by undertaking a comparative analysis of various flat tax designs for selected Western European countries. Davies and Hoy (2002) show that in the case of revenue neutral flat tax reforms there are two sets of critical parameter values: a lower bound of the flat tax rate below which income inequality is always higher