The Global Flat Tax Revolution

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In the early 1990s, Rep. Dick Armey (RTX) proposed a flat tax. He would have junked the Internal Revenue Code and replaced it with a system designed to raise revenue in a much less destructive fashion. The core principles were to tax income at one low rate, to eliminate double taxation of saving and investment, and to wipe out the special preferences, credits, exemptions, deductions, and other loopholes that caused complexity, distortions, and corruption.

The flat tax never made it through Congress, but it's been adopted by more than a dozen other countries since 1994.

It's unfortunate that the United States is missing out on the tax reform revolution. Instead of the hundreds of forms demanded by the current tax system, the Armey flat tax would have required just two postcards. Households would have used the individual postcard to pay a 17 percent tax on wages, salary, and pensions, though a generous family-based allowance (more than $30,000 for a family of four) meant that there was no tax on the income needed to cover basic expenses.

Taxes on other types of income would have been calculated using the second postcard, which would have been filed by every business regardless of its size or structure. Simply stated, there would have been a 17 percent tax on net income, which would have been calculated by subtracting wages, input costs, and investment expenditures from total receipts.

While the simplicity and low tax rate were obvious selling points, the flat tax also eliminated various forms of double taxation, ending the bias against income that was saved and invested. In other words, the IRS got to tax income only one time. The double tax on dividends would have been completely eliminated. The death tax also was to be wiped out, as was the capital gains tax, and all saving would have received "Roth IRA" treatment.

Another key feature of the flat tax was the repeal of special tax breaks. With the exception of a family-based allowance, there would have been no tax preferences. Lawmakers no longer would have been able to swap loopholes for campaign cash. It also would have encouraged businesses to focus on creating value for shareholders and consumers instead of trying to manipulate the tax code. Last but not least, the flat tax would have created a "territorial" system, meaning that the IRS no longer would have been charged with taxing Americans on income earned—and subject to tax—in other jurisdictions.

Proponents correctly argued that a flat tax would improve America's economic performance and boost competitiveness. And after Republicans first took control of Congress, it appeared that real tax reform was possible. At one point, the debate was about, not whether there should be tax reform, but whether the Internal Revenue Code should be replaced by a flat tax or a national sales tax (which shared the flat tax's key principles of taxing economic activity only one time and at one low rate).

Notwithstanding this momentum in the mid-1990s, there ultimately was no serious legislative effort to reform the tax system. In part, that was because of White House opposition. The Clinton administration rejected reform, largely relying on class-warfare arguments that a flat tax would benefit the so-called rich. But President Clinton wasn't the only obstacle. Congressional Democrats were almost universally hostile to tax reform, and a significant number of Republicans were reluctant to support a proposal that was opposed by well-connected interest groups.

The Flat Tax around the World

One of the stumbling blocks to tax reform was the absence of "real-world" examples. When Armey first proposed his flat tax, the only recognized jurisdiction with a flat tax was Hong Kong. And even though Hong Kong enjoyed rapid economic growth, lawmakers seemed to think that the then--British colony was a special case and that it would be inappropriate to draw any conclusions from it about the desirability of a flat tax in the United States.

Today, much of the world seems to have learned the lessons that members of Congress didn't. Beginning with Estonia in 1994, a growing number of nations have joined the flat tax club. There are now 17 jurisdictions that have some form of flat tax, and two more nations are about to join the club. As seen in Table 1, most of the new flat tax nations are former Soviet republics or former Soviet bloc nations, perhaps because people who suffered under communism are less susceptible to class-warfare rhetoric about "taxing the rich."

FLAT TAX JURISDICTIONS	YEAR OF ENACTMENT	TAX RATE
Jersey	1940	20 percent
Hong Kong	1947	16 percent
Guernsey	1960	20 percent
Estonia*	1994	22 percent
Latvia	1995	25 percent
Lithuania**	1996	27 percent
Russia	2001	13 percent
Serbia	2003	14 percent
Slovakia	2004	19 percent
Ukraine***	2004	15 percent
Iraq	2004	15 percent
Romania	2005	16 percent
Georgia	2005	12 percent
Iceland	2007	35.7 percent
Mongolia	2007	10 percent
Kyrgyzstan	2007	10 percent
Macedonia	2007	12 percent
FUTURE FLAT TAX JURISDICTIONS	**GOES INTO EFFECT**	**TAX RATE**
Montenegro	2007 (July)	15 percent
Mauritius	2009	15 percent

*Originally 26 percent. **Originally 33 percent. ***Originally 13 percent.

Flat Tax Lessons

The flat tax revolution raises three important questions: Why is it happening? What does the future hold? Should American policymakers learn any lessons?

The answer to the first question is a combination of principled leadership, tax competition, and learning by example. Flat tax pioneers such as Mart Laar (prime minister of Estonia), Andrei Illarionov (chief economic adviser to the president in Russia), and Ivan Miklos (finance minister in Slovakia) were motivated at least in part by their understanding of good tax policy and their desire to implement pro-growth reforms. But tax competition also has been an important factor, particularly in the recent wave of flat tax reforms. In a global economy, lawmakers increasingly realize that it is important to lower tax rates and reduce discriminatory burdens on saving and investment. A better fiscal climate plays a key role both in luring jobs and capital from other nations and in reducing the incentive for domestic taxpayers to shift economic activity to other nations.

Moreover, politicians are influenced by real-world evidence. Nations that have adopted flat tax systems generally have experienced very positive outcomes. Economic growth increases, unemployment drops, and tax compliance improves. Nations such as Estonia and Slovakia are widely viewed as role models since both have engaged in dramatic reform and are reaping enormous economic benefits. Policymakers in other nations see those results and conclude that tax reform is a relatively risk-free proposition. That is especially important since international bureaucracies such as the International Monetary Fund usually try to discourage governments from lowering tax rates and adopting pro-growth reforms.

The answer to the second question is that more nations will probably join the flat tax club. Three nations currently are pursuing tax reform. Albania is on the verge of adopting a low-rate flat tax, as is East Timor (though the IMF predictably is pushing for a needlessly high tax rate). A 15 percent flat tax has been proposed in the Czech Republic, though the political outlook is unclear because the government does not have an absolute majority in parliament.

It is also worth noting that countries with flat taxes are now competing to lower their tax rates. Estonia’s rate already is down from 26 percent to 22 percent, and it will drop to 18 percent by 2011. The new prime minister’s party, meanwhile, wants the rate eventually to settle at 12 percent. Lithuania’s flat rate also has been reduced, falling from 33 percent to 27 percent, and is scheduled to fall to 24 percent next year. Macedonia’s rate is scheduled to drop to 10 percent next year, and Montenegro’s flat tax rate will fall to 9 percent in 2010—giving it the lowest flat tax rate in the world (though one could argue that places like the Cayman Islands and the Bahamas have flat taxes with rates of zero).

The continuing shift to flat tax systems and lower rates is rather amusing since an IMF study from last year claimed: "Looking forward, the question is not so much whether more countries will adopt a flat tax as whether those that have will move away from it." In reality, there is every reason to think that more nations will adopt flat tax systems and that tax competition will play a key role in pushing tax rates even lower.

Could It Happen Here?

For American taxpayers, the key question is whether politicians in Washington are paying attention to the global flat tax revolution and learning the appropriate lessons. There is no clear answer to this question. Policymakers certainly are aware that the flat tax is spreading around the world. Mart Laar, Andrei Illarionov, Ivan Miklos, and other international reformers have spoken several times to American audiences. President Bush has specifically praised the tax reforms in Estonia, Russia, and Slovakia. And groups like the Cato Institute are engaged in ongoing efforts to educate policymakers about the positive benefits of global tax reform.

But it is important also to be realistic about the lessons that can be learned. The United States already is a wealthy economy, so it is very unlikely that a flat tax would generate the stupendous annual growth rates enjoyed by nations such as Estonia and Slovakia. The United States also has a very high rate of tax compliance, so it would be unwise to expect a huge "Laffer Curve" effect of additional tax revenue similar to what nations like Russia experienced.

It is also important to explain to policymakers that not all flat tax systems are created equal. Indeed, none of the world’s flat tax systems is completely consistent with the pure model proposed by Professors Robert Hall and Alvin Rabushka in their book, *The Flat Tax*. Nations such as Russia and Lithuania, for instance, have substantial differences between the tax rates on personal and corporate income (even Hong Kong has a small gap). Serbia’s flat tax applies only to labor income, making it a very tenuous member of the flat tax club. Although information for some nations is incomplete, it appears that all flat tax nations have at least some double taxation of income that is saved and invested (though Estonia, Slovakia, and Hong Kong get pretty close to an ideal system). Moreover, it does not appear that any nation other than Estonia permits immediate expensing of business investment expenditures. (The corporate income tax in Estonia has been abolished, for all intents and purposes, since businesses only have to pay withholding tax on dividend payments.)

Policymakers also should realize that a flat tax is not a silver bullet capable of solving all of a nation’s problems. From a fiscal policy perspective, for instance, the Russian flat tax has been successful. But Russia still has many problems, including a lack of secure property rights and excessive government intervention. Iraq is another example. The U.S. government imposed a flat tax there in 2004, but even the best tax code is unlikely to have much effect in a nation suffering from instability and violence.

With all these caveats, the flat tax revolution nonetheless has bolstered the case for better tax policy, both in America and elsewhere in the world. In particular, there is now more support for lower rates instead of higher rates because of evidence that marginal tax rates have an impact on productive behavior and tax compliance. Among developed nations, the top personal income tax rate is 25 percentage points lower today than it was in 1980. Similarly, the average corporate tax rate in developed nations has dropped by 20 percentage points during the same period. Those reforms are not consequences of the flat tax revolution. Margaret Thatcher and Ronald Reagan started the move toward less punitive tax rates more than 25 years ago. But the flat tax revolution has helped cement those gains and is encouraging additional rate reductions.

Moreover, there is now increased appreciation for reducing the tax bias against income that is saved and invested. Indeed, Sweden and Australia have abolished death taxes, and Denmark and the Netherlands have eliminated wealth taxes. Other nations are lowering taxes on capital income, much as the United States has reduced the double taxation of dividends and capital gains to 15 percent. And although the United States is a clear laggard in the move toward simpler and more neutral tax regimes, the flat tax revolution is helping to teach lawmakers about the benefits of a system that does not penalize or subsidize various behaviors.

The flat tax revolution also suggests that the politics of class warfare is waning. For much of the 20th century, policymakers subscribed to the notion that the tax code should be used to penalize those who contribute most to economic growth. Raising revenue was also a factor, to be sure, but many politicians seem to have been more motivated by the ideological impulse that rich people should be penalized with higher tax rates. If nothing else, the growing community of flat tax nations shows that class-warfare objections can be overcome.

Building a High-Tax Cartel

Although the flat tax revolution has been impressive, there are still significant hurdles. Most important, international bureaucracies are obstacles to tax reform, both because they are ideologically opposed to the flat tax and because they represent the interests of high-tax nations that want tax harmonization rather than tax competition. The Organization for Economic Cooperation and Development, for instance, has a "harmful tax competition" project that seeks to hinder the flow of labor and capital from high-tax nations to low-tax jurisdictions. The OECD even produced a 1998 report stating that tax competition "may hamper the application of progressive tax rates and the achievement of redistributive goals." In 2000 the Paris-based bureaucracy created a blacklist of low-tax jurisdictions, threatening them with financial protectionism if they did not change their domestic laws to discourage capital from nations with oppressive tax regimes.

The OECD has been strongly criticized for seeking to undermine fiscal sovereignty, but its efforts also should be seen as a direct attack on tax reform. Two of the key principles of the flat tax are eliminating double taxation and eliminating territorial taxation. These principles, however, are directly contrary to the OECD's anti-tax competition project—which is primarily focused on enabling high-tax nations to track (and tax) flight capital. That necessarily means that the OECD wants countries to double tax income that is saved and invested, and to impose that bad policy on an extraterritorial basis.

The OECD is not alone in the fight. The European Commission also has a number of anti-tax-competition schemes. The United Nations, too, is involved and even has a proposal for an International Tax Organization. All of those international bureaucracies are asserting the right to dictate "best practices" that would limit the types of tax policy a jurisdiction could adopt. Unfortunately, their definition of best practices is based on what makes life easier for politicians rather than what promotes prosperity.

Fortunately, these efforts to create a global tax cartel have largely been thwarted, and an "OPEC for politicians" is still just a gleam in the eyes of French and German politicians. That means that tax competition is still flourishing, and that means that the flat tax club is likely to get larger rather than smaller.

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