WALL STREET JOURNAL.

© 2005 Dow Jones & Company. All Rights Reserved

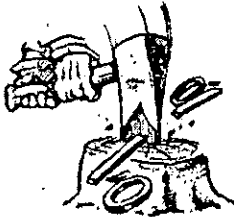
WEDNESDAY, JANUARY 12, 2005 - VOL. CCXLV NO. 8 - ★★★★ $1.00

# Flat and Happy . . .

**By Alvin Rabushka**

Will we ever get real tax reform? For decades, economists, journalists and politicians have been discussing the pros and cons of a flat tax, sales tax, and VAT as alternatives to our federal income tax. One commission after another has conducted hearings and one Treasury secretary after another has overseen studies. Little by way of simplification and reform has come of these efforts. Interest groups and partisan politics have blocked real reform. Every year, Congress further complicates the tax code.

President Bush has just established another commission of nine distinguished members, but it will encounter the usual obstacles. A new round of hearings is not needed. A better approach is for the members to visit the eight countries in Central and Eastern Europe that have adopted the flat tax in the last 10 years and study their experience.


William Bramhall

Estonia was first, implementing a 26% flat tax in 1994. The relatively high rate was set to balance its budget, a requirement of its new constitution. Since then, buoyed by strong economic performance, Estonia has eliminated the corporate tax on retained earnings, taxing only distributed profits. This year the rate has been lowered to 24% and will fall to 20% in 2007.

Next, in 1995, was Latvia with a 25% rate. But Russia is the big story. It took the tax reform world by storm in 2000 with a 13% flat tax, replacing its previous three-bracket system that topped out at 30%. The results: the economy has enjoyed four years of sustained growth. Real (inflation-adjusted) ruble revenue from the personal income tax rose 25.2% in 2001, 24.6% in 2002, 15.2% in 2003, and 16% in the first half of 2004. At the end of just four years, total receipts have more than doubled—despite, or rather because of, a reduction in the top rate from 30% to 13%. The share of consolidated budget revenue received from the personal income tax increased from 12.1% in 2000 to 17% at the end of 2003. It has become the third largest source after corporate income tax and value added tax.

After a pause of three years, the flat tax resumed course. In 2003 Serbia implemented a comprehensive 14% flat tax on personal and corporate income. Not stopping at 14%, Serbia has stated its intention to further reduce tax rates in the near future. Taking a page from Russia's playbook, Ukraine implemented a 13% flat tax in 2004, replacing five brackets ranging from 10% to 40%. Dividends and interest on bank deposits are taxed at an even lower 5% rate beginning 2005. News reports suggest that Ukrainian officials consulted with their Russian colleagues. The advice they received was that incentives and revenue would rise and that the underground economy and tax evasion would decline.

In 2004 Slovakia implemented a 19% flat tax on both individual and corporate income. The measure passed by a vote of 85-48, and garnered the support of some opposition deputies. The 19% flat tax replaced five brackets from 10% to 38% and a corporate rate of 25%. It greatly simplified the previous system which included 90 exceptions, 19 sources of income that were not taxed, 66 items that were tax exempt, and 27 items with their own specific tax rates (e.g. bank interest, honoraria, etc.). Once the corporate tax is paid, dividends received by individuals are tax free.

Georgia's Mikhail Saakashvili was inaugurated as president on Jan. 25, 2004. Five days later he stated that one of his economic priorities was to introduce a new flat-rate tax system. On Dec. 22, 2004, by an overwhelming vote of 107-11, Georgia's parliament approved a 12% flat tax on personal income, replacing the previous system of four rates from 12% to 20%. The flat tax, which took effect on Jan. 1, 2005, reduced the size and weight of the old code by 95%.

In an election held on Dec. 13, 2004, Trajan Basecu, Bucharest's mayor, won a surprise victory as president of Romania. In his campaign he promised to work for a 16% flat tax on both personal and business income, to replace a complicated system of five rates ranging from 18% to 40% on personal income and 25% on corporate income. The first act of his new government on Dec. 29 was the adoption of the flat tax as pledged, effective Jan. 1. Opposition parties in other Eastern European countries, such as the Czech Republic and Poland, have promised to enact a 15% flat tax if they are elected.

Where else is the flat tax under consideration? China, of all places. In November 2003, I was invited by the Ministry of Finance to Beijing to discuss personal income tax reform. A Chinese translation of my book, "The Flat Tax," was published in May 2003 by the China Financial & Economic Publishing House, with a preface by Vice Minister of Finance Lou Jiwei. In recent years, several Chinese professors of public finance have written on the economic and fiscal benefits of reducing China's top rate of 45%, some suggesting a flat 20% rate. Beijing is likely to announce preliminary steps on personal income tax reform in the March 2005 budget.

The flat tax is even spreading to Western Europe. In March 2004, Marjo Matikainen-Kallström, a Finnish member of the European Parliament, announced that she would seek the leadership of the National Coalition Party in Finland, with a vision for a flat tax. Her statement was that a flat tax would cut Finland's high marginal tax rates, thereby retaining top Finns and attracting new expertise to Finland.

Spain's government of José Luis Rodríguez Zapatero is considering a flat tax. Miguel Sebastián, director of the Economic Office of the Prime Minister, favors one and has co-authored a paper titled "A Proposed Reform of Tax System in Spain." His co-author, Manuel Díaz-Mendoza, is currently an adviser on taxation in the Prime Minister's Economic Office. They recommend a 30% flat tax on personal income in place of the current complex system with its top marginal rate of 45%. Even the socialist government of Gerhard Schröder is reviewing a flat tax for Germany. In July, a Finance Ministry panel of 29 academics proposed a 30% flat tax on all personal and corporate income. It would replace the current personal income tax with a top rate of 45% and an effective corporate rate of 38.3%.

If the new Bush commission cannot arrange a road trip to Central and Eastern Europe to see firsthand the success of the flat tax, perhaps it might do the next best thing—invite the finance ministers, prime ministers, and economic experts of these countries to testify.

*Mr. Rabushka is the David and Joan Traitel Senior Fellow at Stanford's Hoover Institution.*