Economic Analysis: Thinking Flat, Going Global

by Martin A. Sullivan

Economics Correspondent Martin A. Sullivan examines the global push for a flat tax.

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The biggest problem with ketchup was getting it out of the container. Then somebody got the bright idea to use an upside-down bottle. It's still ketchup, but it's a lot easier to handle.

The biggest problem with the value added tax was its disproportionate burden on the poor. Then somebody got the bright idea of converting it into a flat tax. It's still a VAT, but it's a lot easier to handle.

Economists like the VAT because it is a consumption tax -- the tax best suited for keeping an economy healthy. But while the rich consume only a fraction of their wealth, the poor consume everything they've got. So without some serious modification to the basic model, most people consider a VAT unfair. Democratically elected governments do not ignore that. But the usual remedies are only partial fixes. Moreover, they are messy -- with special rates and exemptions for items such as food eaten at home, drugs prescribed by physicians, and clothing worn by children.

To the rescue is an idea nothing less than a stroke of genius: The flat tax, a simple variation of the VAT theme that makes its powerful economic medicine easier to swallow.

To make a flat tax, start with your basic garden-variety VAT collected from businesses. Then take a meat cleaver and cut it into two parts. On one side, you have your basic VAT except that the amount that would be subject to business tax is reduced by wages paid by business. On the other side, you have a new personal tax imposed on wages.

By transforming a VAT into a flat tax, the burden on the poor may now be reduced simply and directly through a system of generous personal exemptions. In his new book, *Flat Tax Revolution: Using a Postcard to Abolish the IRS*, Steve Forbes proposes a flat tax that exempts the first $46,000 of wages earned by a family of four.

There are two other hallmarks of a flat tax. There is a single, flat rate for both the business and individual portions of the tax. And except for those generous personal exemptions, it is a tax system with no tax breaks. There are no deductions or credits of any kind.

Domestic Problems

The year 2005 should have been a banner year for the flat tax. If ever there was opportunity for that bright idea to be put into action, this was it. After all, it is the beginning of the second term of a Republican president. His party controls both houses of Congress. He has appointed a tax reform panel. He has made tax reform a priority.

But lightly scratch that surface and you will find the president lacks both the will and the way to enact any type of fundamental tax reform. Out of courtesy to his political base, his advisers have always treated the idea of a flat tax with respect -- but never with enthusiasm. We can expect more of the same from the president's hand- picked panel. And the president has already signaled that he has no intention of eliminating the deductions for mortgage interest and charitable contributions.

Those are not the only bad omens for the flat tax. You don't need a Capital Beltway pundit to tell you that the moribund legislative status of Social Security reform spells trouble for tax reform.

And because the president's plan for personal accounts flat- lined this summer, his strength has only dwindled further. There has been a lack of progress in the war in Iraq, and on top of that, Bush must grapple with "the other gulf war" -- the aftermath of Hurricanes Katrina and Rita, according to Republican Sen. David Vitter of Louisiana.

If that weren't enough, the oxygen keeping the flat tax fire burning is being sucked out by what once might have been considered its natural ally -- the conservative right. That's because there is a plan out there that is even more radical than the flat tax. It would eliminate the need for individuals to file tax returns.

Its backers like to call it the fair tax, but you may think of it simply as a national sales tax. It has a lot of visceral appeal because it would eliminate the need for individuals to file tax returns. There is no chance the fair tax will become law, but it is spoiling whatever chance the flat tax may have had. And to add insult to injury, *The Fair Tax*, the new book by House Ways and Means member John Linder, R-Ga., is far outselling the new book by Forbes.

Foreign Aid

With those gloomy domestic prospects, flat tax proponents have taken solace in the flat tax "revolution" sweeping Eastern Europe. It all started in Estonia in 1994, when Mart Laar, that country's 32- year-old prime minister, ignored conventional wisdom and implemented a single-rate tax of 26 percent with no deductions or credits.

Since then seven other countries have joined the flat tax club. At the Hoover Institution in California, Alan Rabushka, one of the original pioneers of the flat tax, keeps a list: Estonia (1994), Latvia (1995), Russia (2001), Ukraine (2003), Serbia (2003), Slovakia (2004), Georgia (2005), and Romania (2005). And hardly a week passes without new reports of interest in a flat tax in locations from Great Britain to China.

But the two countries where the flat tax has attracted the most press in recent weeks are Germany and Poland.

In August conservative Angela Merkel had a double-digit lead in the polls and was a shoe-in to become the new chancellor of Germany. But Gerhard Schroeder, the savvy incumbent, steadily narrowed the gap with a relentless attack on Merkel's newly appointed economic adviser, Paul Kirkhof, an ardent flat tax advocate. Even though the flat tax was not part of the Christian Democrats' platform, the appointment of Kirkhof -- dubbed by Schroeder the "the professor from Heidelberg" -- allowed the Social Democrats to first confuse and then scare the voters.

The tactic worked. On election day, September 17, Merkel's Christian Democrats tallied only 35.2 percent of the vote against 34.3 percent for Schroeder's Social Democrats. And instead of having a mandate for economic reform, Merkel's center-right party must share power with the center-left.

Similarly, in Poland, anxiety about the flat tax changed the outcome of a recent nationwide election. As widely anticipated, conservatives gained a clear victory on September 25. But there was one unexpected twist. The party known as Citizens' Platform, which strongly favors a flat tax, was supposed to get the most votes and form a coalition with Poland's other center-right party, Law and Justice. But when all the votes were counted, Law and Justice came out on top with 27 percent of the vote. Citizens Platform got only 24.1 percent.

That small swing in the vote has big implications for Poland's taxes. The new ruling party -- headed by former childhood movie stars, the twins Lech and Jaroslaw Kaczynski -- opposes the flat tax. In fact, many commentators attribute Law and Justice's last-minute surge in the polls to its aggressive campaign against the flat tax. So the prospect of a Polish flat tax, until recently considered a near certainty, is now in limbo.

The lesson from Germany and Poland is not that the flat tax is necessarily a bad tax but that it can -- like so many reforms spurred by globalization -- scare voters and lose elections.

Given those recent developments, it appears that at least for the time being, the flat tax crowd is left with eight Eastern European countries. That's still impressive, isn't it?

Well, yes and no.

It is critical to understand that the flat taxes in those countries are not the same as the flat taxes advocated by U.S. conservatives. Six months ago in *Tax Notes*, Clifford Gaddy and Bill Gale of the Brookings Institution detailed the numerous differences between the Russian tax reform of 2001 and the classic presentation of the flat tax by Robert Hall and Alvin Rabushka. ("Demythologizing the Russian Flat Tax," *Tax Notes*, Mar. 28, 2005, p. 1591.)

In Russia, as in most of the other countries with flat taxes, governments have acted in accordance with the flat tax philosophy by reducing rates and eliminating most tax breaks. But that general approach to tax reform is a far cry from the specific flat tax plan originated by Hall and Rabushka and since propagated by Forbes and others. Those countries have in fact retained many features that are anathema to fundamental tax reformers. They have, for example, retained their VATs at high rates. Also, they have retained their corporate income taxes and shunned implementation of the business component of a flat tax. And in some cases, even though rates are flattened, they are not entirely flat. Their corporate and personal income tax rates differ, sometimes substantially. In Slovakia and Serbia, for example, there are still multiple rates.

In Name Only

Governments -- especially those in developing economies with massive compliance problems -- are going to lower rates and broaden their tax bases no matter how many books Americans write on tax reform. It is just icing on the cake for those governments, hungry for foreign investment, that they can call their modified systems "flat taxes." Not only is it free advertising but it's also advertising targeted to the investor class.

What better way for former communist countries to signal their capitalist renaissance than by appearing to embrace the fiscal ideas of U.S. conservatives? What better way for the American flat tax movement to claim continuing success than to go beyond textbook presentations and point to tangible progress in other countries? But to force that square peg into a round hole, the "receiving" governments and the "donating" conservatives have let the definition of the flat tax slip. That hasn't caused much fuss because it is to the mutual advantage of both parties.

It is to our advantage, however, to look beyond the slogans and see the flat tax "revolution" for what it really is. The world is becoming more global. Capital and even labor are more mobile. Out of necessity, governments around the world are responding with lower rates and broader tax bases. That is the good side of tax competition. International forces are bursting the political coalitions that have kept high-rate, loophole-ridden tax systems viable.

What is called the flat tax revolution is only a small part of a worldwide transformation in taxation. The flat tax is a neat idea, but it has political limitations. It certainly is not the driving force behind tax reforms around the world. It is just along for the ride.

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