Viewpoints

Eastern Europe's Flat Tax Revolution

by Daniel J. Mitchell

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Less than two decades ago, the Iron Curtain divided Europe. Based on the Marxist notion "From each according to ability, to each according to need," the Soviet Union and its vassal states in Eastern Europe were ideological rivals to the West. It is ironic, therefore, that nations in the former Soviet Bloc have thrown off the shackles of communism and are competing with each other to adopt flat tax systems with the lowest possible rate.

Estonia was the first to adopt a flat tax, implementing a 26 percent rate in 1994 just a few short years after the collapse of the Soviet Union. The other two Baltic nations enacted flat taxes in the mid-1990s, with Latvia choosing a 25 percent rate and Lithuania picking 33 percent. Along with other free market reforms, the flat tax significantly improved economic growth, and the "Baltic Tigers" became role models for the region. Learning from its neighbors, Russia stunned the world with a 13 percent flat tax that went into effect in 2001. Showing that truth is stranger than fiction, the former "Evil Empire" adopted a flat tax 4 percentage points lower than the supposedly radical 17 percent flat tax proposed by former U.S. Rep. Dick Armey and presidential candidate Steve Forbes.

The Russian flat tax quickly yielded positive results. The economy prospered and revenues poured into government coffers as tax evasion and avoidance became much less profitable. The flat tax then spread in 2003 to Serbia, which chose a 14 percent rate. Slovakia hopped on the bandwagon the following year with a 19 percent flat tax, as did Ukraine, which chose a 13 percent tax rate. Romania joined the flat tax revolution earlier this year with a 16 percent tax, along with Georgia, which has (at least temporarily) the honor of having the lowest rate — just 12 percent.

The flat tax revolution has been so successful that Estonia is lowering its rate to keep pace with other nations. The Estonian flat tax is now down to 24 percent and it will drop to 20 percent by 2007. But this may be just the tip of the iceberg. Lawmakers in Croatia, Bulgaria, and Hungary are discussing the flat tax, and opposition parties in Poland and the Czech Republic have promised to implement 15 percent flat tax regimes if they win the next elections.

The flat tax steamroller is causing considerable trepidation in Western Europe's welfare states. Leftist politicians and their lackeys in the European Union and the OECD complain about "harmful" tax competition. But these complaints are falling on deaf ears in the East. Having endured decades of communist enslavement, leaders in Eastern Europe are unlikely to be intimidated by socialist complaints from Paris and Brussels.

Indeed, some Western European lawmakers see the handwriting on the wall and have begun to talk about the possibility of the flat tax in their countries. While there certainly is not yet a political consensus for reform, Spain, Denmark, Holland, and Germany are among the nations that are examining the flat tax. The fact that these discussions are even taking

place is a testimony to the liberalizing force of tax competition. And if the rumors are true about the People's Republic of China implementing a flat tax sometime this year, the tax reform steamroller may become a juggernaut.

But just because nations are rushing to adopt flat taxes does not necessarily mean it is a good idea. After all, numerous countries nationalized industries after World War II, only to discover that government-owned companies became inefficient burdens.

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By every indication, however, the flat taxes in Eastern Europe are a win-win situation for both the governments and the private sectors. All of the Baltic Tigers are enjoying strong growth, averaging more than 5 percent per year. This robust economic performance is generating plenty of tax revenue for government coffers. Russia is another success story. The economy has rebounded from a crisis in the late 1990s, and inflation-adjusted personal income tax revenues have increased by more than 100 percent in the four years since the flat tax was implemented. The flat tax systems in the other nations are so new that it is difficult to draw conclusions, though it is worth noting that both economic growth and tax collections exceeded expectations in the first year of Slovakia's flat tax.

This good news is to be expected. The flat tax embodies all the principles of good tax policy, including:

- Tax income at the lowest possible rate to encourage pro-growth behavior. The marginal tax rate is a price that government imposes on productive economic behavior. Flat tax systems are designed to have a low rate, meaning that individuals are not penalized for work, risk-taking, and entrepreneurship. Eastern European nations certainly understand this principle. Flat taxes in the region, on average, are less than 19 percent (and the rate is only 17 percent if Lithuania's abnormally high rate is not counted).
- Tax income only one time so there is no bias against saving and investment. A key feature of a pure flat tax is the elimination of the tax bias against income that is saved and invested, which means no death tax, no capital gains tax, no double tax on dividend income, and IRA treatment for all saving. Not all of the Eastern European flat taxes have fulfilled all these criteria, but double-taxation of capital has been substantially reduced.
- Eliminate social engineering and industrial policy by removing special-interest loopholes. Special tax breaks distort the allocation of resources and thereby undermine economic growth. The flat tax seeks to eliminate or minimize the impact of the tax code on decisionmaking by treating all income equally, regardless of how it is earned or how it is spent. Eastern European nations, especially Slovakia and Estonia, dramatically have reduced privileges in the tax code.

Other important principles of good tax policy are satisfied by the flat tax, including simplicity and territoriality. For all of these reasons, flat taxes in Eastern Europe have been a success — and the evidence of their success will become even more apparent with the passage of time. Indeed, this is why some opponents of tax reform are trying to disparage the amazing developments in Eastern Europe. They correctly fear that these nations are examples for America and other Western nations.

To be sure, Eastern European nations do not have perfect tax systems. None of them have adopted the pure Hall-Rabushka flat tax, and many of the countries are still plagued by oppressively high payroll taxes. But the perfect should not be the enemy of the good. Tax reform in Eastern Europe is a great success, and the United States can learn from what has been accomplished in other nations. The U.S. economy probably would not grow quite as fast as Estonia's if it adopted a flat tax, and it is unlikely that the government would get the same revenue windfall as Russia if it enacted a flat tax.

But a flat tax in America would mean a stronger economy, just like it has meant faster growth in Eastern Europe. A flat tax in America would improve tax compliance, just as it has reduced evasion and avoidance in Eastern Europe. A flat tax in America would reduce political corruption, just as it has curtailed interest-group pleading in Eastern Europe. A flat tax in America would boost capital formation, just as it has been a magnet for new investment in Eastern Europe.

The most important lesson, however, is that a nation can break free from the poisonous influence of class warfare. Having experienced the terrible consequences of an economic system based on "from each according to ability," the Eastern Europeans have instead chosen tax systems based on the principle that all citizens should be treated equally. During his recent trip to Europe, President Bush congratulated Slovakia and said it was his dream to have a flat tax in America. Let's hope that dream becomes a reality. ◆