

## **THE PRACTICALITIES OF FLAT TAX**

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### **1. Doesn't flat tax simply mean cutting taxes?**

On the contrary, it usually involves *increasing* the total amount of taxation. It involves setting a single rate of income tax, which in practice is almost always lower than most of the existing graduated rates. But a lower rate does not mean a lower yield. In practice countries which have introduced flat tax have increased tax revenues.

### **2. Surely a flat tax will give the government less to spend on social needs?**

No. It should have more to spend. A flat tax raises the tax base in three ways. Because the flat rate is low and simple, people no longer resort to complicated means of sheltering their income from tax. Out go the complex schemes under which companies trade off-shore from addresses in the Caribbean. Out go the trusts and the claims for tax allowances and write-offs. It becomes cheaper to pay the tax than to pay the accountants.

This means that more income becomes taxable. People who previously evaded tax illegally now find it more worthwhile to pay the new low rate than to risk prosecution and imprisonment. This means that much of the 'black economy' surfaces and is taxed.

Finally the tax base rises in a third way. Because the rates are low, the incentive to do more work, to invest, and to expand are all increased, so the size of the economy also increases as more wealth and jobs are created. And the wealth stays, too, because people find it less necessary to emigrate.

### **3. Doesn't flat tax hurt those on low earnings?**

In practice, no. The threshold at which people start to pay the flat tax is set high enough to exclude low earners altogether. Only money earned above that level qualifies for the tax. The proposal made in Britain, for example, is for a threshold set roughly at the minimum wage, which is about half the average earnings. The starting threshold will vary from country to country, but the principle should be to avoid taxing low earners. Cutting them out of the tax trap will make more of them independent of the need for government social support.

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At the Institute, Dr Pirie was part of the influential team which pioneered privatization and the extension of market choices and incentives. His work in helping to develop the Citizen's Charter led to his appointment to the Prime Minister's Advisory Panel from 1991-95.

A graduate of the universities of Edinburgh, St Andrews and Cambridge, Dr. Pirie is author of several books including *The Book of the Fallacy*, *Micropolitics*, *Privatization in Theory and Practice* and *Blueprint for a Revolution*. With his colleague Dr Eamonn Butler, he has co-authored a series of books on IQ, including *The Sherlock Holmes IQ Book*.

The Institute itself remains at the forefront of a worldwide movement towards competitive free markets and free trade.

#### **4. Flat tax is just a gimmick to cut taxes for the rich, isn't it?**

Not at all. It certainly cuts the *rates* at which most rich people pay tax, but if done properly it should increase the amount of tax they pay in total. The high earners pay a larger total amount, but a lower proportion of their income.

There is another beneficial result. After a year or two while it beds in, the top 10 percent of earners end up paying a higher share of the total tax bill. Meanwhile low earners are mostly exempt or pay trivial amounts. This result followed the 1980s tax cuts under Reagan in the US, and under Thatcher in the UK. Flat tax will be set to achieve similar results.

#### **5. Isn't it fairer if the rich pay a higher proportion of their income?**

No. It is fairer if the rich pay a higher proportion of the *total tax bill*. It isn't the proportion of their income that matters; it is their share of the total. If we can raise more money and have richer people paying a bigger share of it, most people would call that a fairer system. It is what flat tax does.

#### **6. Won't a flat tax be difficult to monitor and collect?**

The reverse is true. Because a flat tax system removes most of the exemptions and allowances of the graduated (progressive) system, it needs much less work to police it. The tax authorities need less information about people and their circumstances, and do not need an army of inspectors to make sure people are not making false claims.

Under flat tax the authorities only want to know how much you earn. Most of the extra information they now need becomes irrelevant since all taxpayers pay the same rate. Tax collection will be far easier to administer, and far less costly to perform.

#### **7. Will it be difficult to define income, given all the different ways in which people can seek their rewards?**

No more than at present. In fact for nearly everyone it is what they are paid by their employer or what they earn as self-employed people, and is very straightforward. The Finance Ministry will want to make sure that people are not cheating by taking their reward in other ways, but they do that already, and there would be far less reason for people to do that with a flat tax system.

In any case, income tax is only one strand of flat tax, though it is the most important one. Ideally it should be only a first step, with subsequent moves to bring down taxes on capital gains and businesses to comparable rates.

#### **8. Perhaps flat tax works for less advanced economies, but is not appropriate to a modern, developed economy?**

Not so. It has been done first in less advanced economies, but that is for political, not economic reasons. Countries whose economy is less advanced, including former communist

states, do not have the long history of entrenched interest groups influencing the democratic process. Politicians in countries with a longer democratic tradition have to be careful in taking on groups which perceive benefits to themselves from progressive tax systems. Some see advantages in the exemptions and allowances which characterize progressive tax systems, and fear they might lose out on any changes.

This means that it takes political skill and leadership to bring flat tax to sophisticated economies. Once they do it, however, it will work just as well there, if not better. They usually have a more mature and efficient civil service, and a system of tax collection which maximizes collection from the tax base. They generally forfeit less tax to criminal evasion, but more to legal and complex avoidance.

The advanced economies suffer the adverse effects of high tax rates because those rates are enforced, and therefore have much to gain when they are lowered to a single flat rate. The incentive boost to economic activity is probably higher in a more developed economy. And since they have other factors which make them attractive to investors, including clear property rights and business law, the move to a low flat tax increases their attractiveness to foreign investors.

Flat tax becomes politically easier as more countries introduce it. As it spreads from the Baltic states through Eastern Europe, and is taken up by major countries such as Poland, the competitive pressure is felt to keep other countries attractive to enterprise and investment.

## **9. But doesn't flat tax risk a 'race to the bottom' as countries compete for lower rates?**

Certainly those countries which do not take it up risk being left behind in the drive to promote growth and to encourage people to put money into enterprise and expansion. But this is not a 'race to the bottom' but a 'competition in virtue' because it increases economic growth in the countries which do it. If some of them are able to do it because their partners and rivals do it first, this is a good thing and a benefit to their people.

In many cases a country which sets an initial flat tax and gains the benefit of higher tax revenues and economic growth, will be able subsequently to lower their flat rate and achieve similar success.

## **10. But does flat tax represent the sort of future that Europe wants for itself?**

Yes, very much so. Europe cannot insulate itself from the world with high tax rates which make it an unattractive place to do business. If it does it will face economic decline and rising unemployment, as some of its members already have. European countries which tread the flat tax route will be able to combine their social spending with competitive economies which can hold their own in a global market-place. Change is in the air of Europe as people recognize how out-dated its original model is now. China and India have emerged and expanded as global players, and Europe needs to face and co-exist with the world they inhabit. Europe will not do this by the kind of tax harmonization which Brussels once thought it could impose. It can achieve it by the growth and dynamism which flat tax can bring to its economies. This is a future which Europe can join with confidence and enthusiasm.