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The Flat Tax in Russia and the New Europe

by Alvin Rabushka

On January 1, 2001, a 13 percent flat tax on personal income took effect in Russia. It replaced a three-tiered system with a 30 percent top rate on taxable income exceeding $5,000. The old system was complicated, and because of the high rates evasion was widespread. It also produced little revenue. The new flat tax has achieved greater compliance due to its simplicity and low rate. It is producing far more revenue than the former system.

Other nations that have adopted a flat tax, mostly former Soviet satellites, are having similar success. Within a few years, a quarter of the world's people may live under the more efficient, productive and fairer system of a flat-rate income tax.

The United States and other developed countries could learn from the experience of Russia and other emerging market economies.

Russia's Experience with the Flat Tax. President Vladimir Putin proposed a flat-rate income tax to replace the income tax in order to increase government revenues by reducing tax avoidance.

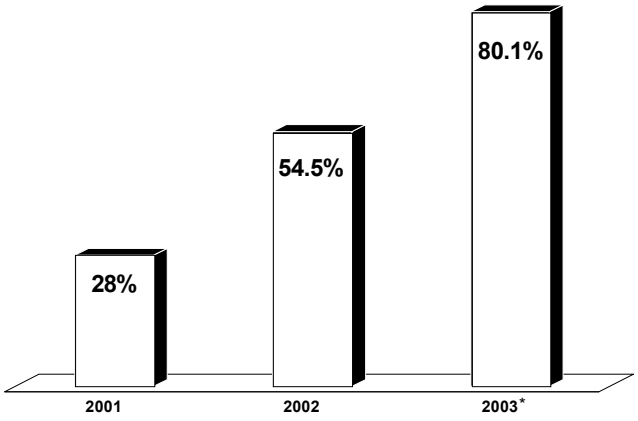
Putin's predecessor, Boris Yeltsin, had followed the advice of the International monetary Fund (IMF) and raised tax rates as high as 30 percent to increase government revenues. This "progressive" income tax system — in which taxpayers face higher marginal tax rates as they earn more money — had failed to raise much money, and it encouraged tax evasion.

Russia also reduced the corporate tax rate from 35 percent to 24 percent, effective January 1, 2002. Additionally, it enacted a flat-rate small business tax — the lesser of 6 percent of gross sales or 15 percent of profits. Other tax reforms included reducing the business sales (turnover) tax rate; replacing separate taxes for pensions, social insurance, medical insurance and unemployment with a unified, lower social insurance tax rate; eliminating most small nuisance taxes and tax privileges; and reducing customs duties.

During its first two years, Russia's 13 percent flat tax exceeded all expectations. As the figure shows:

- In 2001, the first year under the flat tax, personal income tax revenues were 28 percent higher than in 2000, after adjusting for inflation, and rose another 20.7 percent in 2002 compared with 2001.
- For the period January to June 2003, compared with the same period last year, personal income tax revenue increased 31.6 percent.
- After adjusting for anticipated inflation of about 15 percent annualized over 2003, real rubles from the personal flat tax increased 16.6 percent year-over-year.

Increase in Russia's Personal Income Tax Revenues Under Flat Tax
(total since 2000)



* January to June.
Source: Ministry of Taxation of the Russian Federation.

Revenue for personal income taxes also rose relative to other revenue sources:

- The share of tax revenue from the personal income tax rose from 12.1 percent in 2000 to 12.7 percent in 2001.
- In 2002, the flat tax generated 15.3 percent of total tax revenue.

Income tax revenues have grown from a relatively unimportant source of revenue a few short years ago and now exceed excise taxes and taxes on natural resource use. Personal income tax revenue is fast catching up with revenues from the corporate income tax and value added tax. Russia's total tax revenue has grown appreciably since the implementation of the flat tax.

Russia's rate of growth in Gross Domestic Product (GDP) also hit a record 9.0 percent in 2000, after adjusting for an 18 percent inflation rate. Although the

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economy grew at a slower rate in 2001 (5.0 percent) and 2002 (4.3 percent), revenues continued to rise. Thus the rise in revenue cannot be attributed solely, or even largely, to growth, suggesting that the cause is greater compliance and efficiency in tax administration.

The Flat Tax In Other Countries. Following Russia's adoption of the flat tax, Ukraine's parliament overwhelmingly approved its own 13 percent flat tax on personal income (to take effect January 1, 2004). The Ukrainian flat tax replaces five brackets of 10, 15, 20, 30 and 40 percent.

Dividends and interest on bank deposits will be taxed at an even lower 5 percent rate beginning January 1, 2005. As in Russia, Ukraine reduced its tax rate on company profits from 30 to 25 percent. Ukraine's finance minister is also seeking a reduction in the value added tax from 20 percent to 15 percent.

New Europe Adopts the Flat Tax. Ukraine is one more among a growing number of countries that has adopted a flat tax. In Europe, they include Estonia (implemented in 1994), Latvia (1995), Russia (2001) and now Ukraine (2004). Others are expected to follow:

- Belarus intends to harmonize its tax code with Russia's.
- The Slovak Republic is about to enact a 19 percent flat tax for both individuals and corporations (effective January 1, 2004); the reform represents a sharp reduction from personal income tax rates that now run as high as 38 percent and from the current 25 percent levy on corporate profits.
- Not to be outdone, the opposition Civic Democratic Party (ODS) in the Czech Republic has drawn up plans to replace the progressive tax system, which has a top rate of 31 percent, with a 15 percent flat tax on both personal and corporate income.

The Flat Tax in China. Even more exciting is the prospect of a flat tax being adopted in the People's Republic of China. A Chinese edition of *The Flat Tax* by Robert E. Hall and me has just been published by the China Financial & Economic Publishing Company. The flat tax will be the focus of a one-day international seminar in China with Ministry of Finance officials and representatives of the IMF on tax reform. In addition, Chinese professors of public finance have written articles on the benefits of sharply reducing China's top personal income tax rate of 45 percent to no more than 20 percent.

Adding China to the above list would mean that more than a quarter of the world's population would conduct their economic and financial affairs under a flat tax. If so, the producers in China, our largest future competitor, would have a big advantage over American producers — who, barring any real tax reform, will remain saddled with higher tax rates and greater complexity.

Meet the U.S. Income Tax. The federal income tax is a mess. It's not efficient. It's not fair. It's not simple. It's not comprehensible. It fosters tax avoidance and cheating. It costs billions of dollars to administer. It costs taxpayers billions of dollars in time spent filling out tax forms and other forms of compliance. It costs the economy billions of dollars in lost output of goods and services from investments being made for tax reasons rather than economic ones. It involves tens of thousands of lawyers and lobbyists getting tax benefits for their clients instead of performing productive work. It can't find 10 serious economists to defend it. It is not worth saving.

Why Flatten Taxes? In contrast, the flat tax is much less biased against savings and investment than the traditional income tax system. In America, income is taxed once when it is earned and a second time when it is invested. The flat tax does not double tax corporate income or impose a capital gains tax on stocks, bonds and home sales. With few exceptions, there is no double tax on bank deposit interest.

A flat tax will influence the American economy profoundly: Improved incentives for work, entrepreneurial activity and capital formation will substantially raise national output and the standard of living.

Conclusion. A May 28, 2000, *New York Times* editorial praised President Vladimir Putin's 13 percent flat-tax plan, saying that it would reduce corruption, remove subsidies from favored constituents, raise the money to pay for badly needed services and establish the credibility to push for further reforms. A viable tax system, said the *Times*, would allow the Russian government to deal with its failing health system and poverty.

Unfortunately, the *Times* has not endorsed a similar change in the U.S. tax system.

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