Flat-Rate Taxes on Income – Between Oblivion and Perspective

Observations and lessons from history, in Bulgaria and other countries

Skattebetalarna:

Foreword

The debate on how to create a fair and efficient tax system is never-ending. And rightfully so. As business, government and consumption change and develop over time, the tax system needs to adapt to stay in line with its original ideas. But what are those ideas? From our point of view a tax system exists first and foremost to provide the – hopefully limited – government with sufficient funds, without causing too much harm to the economy or control over people's life. That is in sharp contrast to a tax system that has the primary agenda of creating equality through distribution. We believe that the tax system also must be fair, minimally intrusive and support growth.

In recent years there has been a global shift towards advocating higher and more progressive taxation, driven by the G7, the OECD and the IMF. Global, and in many cases higher, taxation on corporate income is suggested, and so is more progressive taxation, especially on labour income, to reduce inequality and thereby promote prosperity and growth. But the correlation between more progressive taxation and reduced inequality is not as clear as the IMF, for example, would argue. On the contrary, flat tax schemes seem to be better suited to creating prosperity and in the long run reducing poverty and inequality.

Professor Krassen Stanchev meritoriously goes through the history and advantages of a flat income tax. Today 21 countries have a flat tax, and it is obvious that this has been successful. The tax systems in these countries are simpler and generate higher tax revenue for the governments. Many of the countries in the report do, however, lack functioning institutions. A valid point is that a flat tax is no substitute for good institutions, but the important lesson is that a flat income tax will probably work even better in countries with good institutions. Historically one could argue that none of the rich countries in the world have become rich with a progressive taxation scheme, in fact the opposite seems to be more historically accurate. Progressive taxation in rich countries only seems to be developed when we are already rich. This raises vital questions concerning the advocacy for higher and more progressive taxes, especially in countries lacking prosperity.

In Sweden we have high and progressive taxes on income and are wrestling with a high general payroll tax. These taxes relate to contributions, but only up to a certain level of income. This makes the Swedish system multi-progressive. A first step for countries with this type of tax system would be to cut the progressive income tax. In Sweden that would mean that the state income tax of an extra 20 percent on medium to high incomes would be abolished. This would probably result in strong dynamic effects, encouraging more highly productive people to work harder, seek promotion or move to Sweden. This would also be more efficient, and fair. And it would be a good start for Sweden to lower our taxes and show other high tax countries the benefits of lower taxes on income.

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Executive Summary

The report analyses the proportional or "flat" taxation of income, especially on labor income. There are taken in two simultaneous and inter-weaving contexts of the matter: the current global debates on corporate taxes (driven by G-7 and OECD) and on progressive and, effectively, wealth taxes advocated by IMF.

Context

These two contexts are often taken in isolation from one another. This approach fails to take into account the fact that the two types of income taxation from the standpoint of the taxpayer stem from the same source – the performance of the enterprise sector and the productivity of labor and other factors of production. On other hand, the definition of "income" is frequently too narrow, which leads to exclusion of social security contributions (or taxes on labor, or tax wedges on the take home pay) from the analysis of tax systems, irrespectively the rich statistics on these taxes.

In effect, the flat tax reforms are only partially represented and the emphasis is put on inefficiencies of the respective systems in addressing income inequalities and securing "inclusive growth", in the jargon of IMF and the World Bank.

The historical and theoretical contexts of introduction of income taxes and especially of progressive taxes is also missing. Eventually, the conventional analysis of the flat tax jurisdictions seems shortsighted and fixated on countries that in one form or another had returned to progressive taxation, while conceivable lessons for the "traditional" progressive tax jurisdictions of OECD were paid little to no attention.

Content

The report makes and attempt to compensate for this shortsightedness of the conventional discussion of flat tax reforms and their outcomes.

Its first section reviews the current global advocacy for higher and more progressive taxation on income, especially the argument for inclusive and equitable economic growth. IMF research on the matter predominantly with redistributive tax policies; other prosperity drivers, such as the technological change, business cycles, labor market regulations, financial globalization and education are discussed as factors of complexity and divergence. The applicability of the poverty indicators, which is also used as an argument for tax reforms to higher and progressive taxes, is similar. This is one of the arguments behind the G7's proposal for a global minimum corporate tax for relatively large companies.

The second section gives an information on the overall dynamics of the flat tax reforms in the last 30 years, but analyses in some detail the experience of the countries that had returned to progressive taxation or applied partial proportional taxation reforms.

Here the cases of Slovakia, Poland and the Russian Federation give an insight on challenges the respective reforms faced.

- The Slovak Republic introduced a flat tax on personal, and corporate and personal income (with non-taxable minimums), and unified the VAT rates but retained the practice of annual definitions of "subsistence levels" of income, thus contributing to "hidden" progressivity of the system.
- Poland applied flat rate of 19% only for the income from business activities and capital gains. The reform coincided with the year of formal membership in the EU (as one of the motives for the reform), after seven successive years of gradual reduction and unification of the tax rate from the top marginal rate of 40%. Since 2014, tax preferences have been introduced for young employees, small businesses, etc. but according most recent statistics corporate taxes remained the most important source of government revenue (as high as in Germany, Slovakia, Slovenia and Spain).

- In some sense, the story of the Russian Federation flat tax on personal income of 13% is unique: in fact there were multiple flat rates on different sources of income with times larger thresholds (e.g. the rate on corporate income 20–30% in 2001, 24% between 2002 and 2008, 30% social security taxes, 30% dividend tax and 5% municipal corporate income tax). At the same time, if one excludes the revenue from export taxes levied on petrol and natural gas supplies abroad, the government of Russia was running an average annual budget deficit of approximately 6% of GDP. The levies on personal income had never been a prime source of revenue for the government, and, in fact the system was not completely flat, it had two rates of 0 and 13%. As popular measure, from January 2021 the annual personal incomes of above USD 67,000 were taxed at 15%. The reform only marginally improved the budget revenue, 1.1 bln, (half of it paid by residents of Moscow), while the total government spending for the year was USD 645 bln.

The third section visits the theoretical and historic contexts of the 19th and early 20th century introduction of income taxes in general, and the progressive taxation in particular.

Two opposite views on proportionality and/or progressiveness are presented – that of John Stuart Mill and his "On the General Principles of Taxation" and Cohen Stuart's "On Progressive Taxation". Knut Wicksell's "New Principle of Just Taxation" is interpreted as theoretical and practical attempt to synchronize the contradictory approaches to tax policies.

The brief review of historic experience on taxing income covers the 19th century Britain and the institutional example of Sweden as well as the post-World War One tax reforms of the United States and some other OECD and G-7 countries, especially with key statistical evidence on composite effective tax rates and wealth taxes.

The fourth section of the report represents the Bulgaria and other country experiences of flat tax reforms.

It briefly reconstructs the background of the reforms, discusses the factors of success and issues of causality between tax changes, economic performance, FDIs and wealth accumulation. From all proportional tax jurisdictions in the EU Bulgaria's system seems flatter: it applied no non-taxable thresholds, same rates for personal and income taxation (of 10%), almost 100% unified VAT rate, while social security contributions represent a higher tax on labor but tax wedges are the same for low and high wage earners, similar but much lower in comparison to tax wedges in Hungary, Poland or Romania.

The reform campaign reconstruction gives additional insight on how the 10% threshold was determined and how original reform objectives and principles of simplicity, proportionality and social acceptance, similar to all countries, were eventually modified in the 10-year period of advocacy for the reform (from 1997 to 2007). The social acceptance was the key political argument, so the campaign after 2003 used as an instrument of "public education" the so called "annual alternative state budgets" compiled at the assumption of 10% taxes, balanced budgets and retained levels of welfare and social aid spending.

Conclusions

With regard to Bulgaria

Bulgaria's tax system factors-in features essential for tax compliance, such as simplicity, build-in compliance incentives, and motivation towards higher income achievements, and so on. A 2019 report on effective tax rate for multinational firms, commissioned by the Greens in the European Parliament, found that from all EU member states the statutory required taxes are paid only in Bulgaria.

The tax system work well in recessions, allowing for relatively flexible counter cyclical policies, when revenues from corporate taxation declines.

Since the tax simplification and base consolidation started in 1999–2000, and especially after proportional tax reforms of 2007–2008, the budget registered sizable surpluses, increased transfers to the State Pension Fund almost three times, and doubled the amount of annual procurement on infrastructure. And the fiscal reserves helped weathering the negative impacts of 2009–2010 recession, covering lost savings as a result of a major bank bankruptcy (in 2014–2015, equal to 3% of GDP), and payment on lost arbitration case (1.2% of GDP to ROSATOM in 2016), and served as prime source of financing all COVID-19 measures in support to retain employments, assist negatively affected sectors and increased needs of healthcare and social aid sectors. The efficacy of the system is well documented by the annual budget perfor-

mance reports from the Ministry of Finance of Bulgaria since 2007.

With regard to all countries

In flat tax jurisdictions the direct taxes, both personal and corporate, constitute a relatively small component of overall tax revenues but the levels are comparable to average OECD countries, as share of GDP. The system relies on low rates, no non-taxable income threshold, and is applied uniformly over a very broad tax base, while the government spending is financed by indirect tax revenue, especially VAT.

The country reforms with compromised "flatness", such as "zero" and unified rates on income above certain threshold, seem less stable. In almost all countries that have given up the proportional levies on income (irrespectively corporate and personal) the motivation to revoke the system had come from the management challenges of the pension systems but the counter-flat reforms did not improve those systems and resulted in restoration of tax-wedge levels of the time before the introduction of flat taxes.

The 2021 Index of Tax Burden on Global Workers had found that: "flat tax regimes impose a fixed rate on income tax, but not other taxes: Social security rates in flat tax countries are, on average, higher than in progressive states; social contributions make up 77.6% of payroll taxes collected in flat tax countries (versus 65.9% in progressive systems)".

In comparison to other countries, Bulgaria's experience proves that any tax system could be made a good deal simpler. But it also allows for making two important conclusions.

- First, with all its positive aspects and fortunate coincidence of the flat tax reforms with up-trends in the business cycle, favorable international economy or political developments (such as Bulgaria's accession to the EU), these reforms are no substitute for better functioning of the institutions.
- Second, it is possible that in countries with better function of the institutions, flatter and simpler taxes could yield better results.

Current initiative for higher and more progressive taxation

The IMF's call for an increase in income taxes was launched in the first public statement of the IMF Managing Director Kristalina Georgieva in 2020 (Georgieva 2020). "Reduce inequality to create opportunities." In global context, this statement awakened the then dormant urge to raise taxes. If they do, the effect is unlikely to be positive.

To be precise, Kristalina Georgieva has actually recommended an increase in the marginal tax rates. Her advice has been justified by awareness that "inequality in the world has increased over the last ten years". And this has been but the first of three tips, the other two being to reformulate social policy (which should be made "more active") and to reform the structure of economy (active employment policy, greater labor market mobility and appropriate housing, credit and infrastructure policies, geographical focus, etc.). IMF also appeals for reducing gender inequality, fighting against corruption and e-government, and surveillance of taxpayers as a means to enhance fiscal redistribution.

What all of these appeals, proposals, arguments and calls for tax reform have in common is the belief that governments will be able to cope with the task and that most of the taxes collected will be rationally used eventually.

Inequality and poverty as arguments for progressive income taxes?

IMF most recent research (Dabla-Norris et. al., 2015) gives no clear justification that tax systems can resolve inequality challenges and what motivated the return of some former flat tax jurisdictions to progressive taxation is far from clear.

The emphasis on "inequality" in the interpretation and implementation of the mission of IMF and the World Bank has been observed for the last five years.[1] Since it is a complex and somewhat incomprehensible phenomenon, references to "growing" inequalities are not entirely correct. Direct income taxation needs not necessarily be perceived as an instrument to address inequality. Rather, it ought to be perceived by politicians as a suitable way to manage welfare policies that may be financed by other sources.

The IMF paper (Dabla-Norris et al., p. 11) states that income inequality (measured by the GINI coefficient) has varied significantly over the last 20 years in different regions of the world (from 5% to 26%) in the former communist countries (including China, India, the Baltic States, Romania, Bulgaria, Slovakia, Croatia, Slovenia and Russia). These are the countries with the highest GDP growth in Europe and the world in the last twenty years. In "richer" economies, the growth of income inequality is below 5%. In the review of inequality drivers (p. 18–22), the report mentions only one directly associated with taxation – the redistributive policies. Other drivers are technological change, business cycles, labor market regulations, financial globalization and education. In a sense, the macro-data of IMF confirms and adds details to contemporary workings of the famous Kuznetz Curve (economic growth increases inequality). According to Branko Milanovic, who until recently led the World Bank's research team on social policies, the post-1952 global inequality has been reduced by about a third , if one take into account the share of population that was positively affected (Milanovic 2016, 2017).[2]

Similar is the applicability of poverty indicators, which is also used as an argument for tax upgrade to higher and progressive taxes. This is one of the arguments behind the G7's proposal for a global minimum corporate tax for relatively large companies. (More of it below.)

Sir Angus Deaton (2013) describes the reduction of poverty in a convincing way and his lecture on receiving the Nobel Prize in Economics dwells precisely on his contribution to study of poverty. In 2001, poverty reduction was included in the agenda of the IMF and World Bank mission. Over the last 20 years, extreme poverty (USD 1.9 per person per day) has fallen about three times, from 28.6% of the world's population in 1999 to 9.9% of the world's population in 2019. 2/5 of the population in question live in Sub-Saharan Africa.

The IMF mission requires, at least in the countries where it supports these systems, to consider economy as subordinated to the fiscal system and, accordingly, as a major corrective to social policy and inequality. The primary mission of the IMF (since 1947) has been to provide guarantees for restructuring of government liabilities, sharing the risk globally in case indebted governments decide to adopt any policy in this respect. The latter will basically consti-

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1) The last substantial reformulation of both institutions' missions took place at the turn of the century (between July 1999 and March 2000), when the US House of Representative commissioned a review of the Bretton Wood's institutions by International Financial Institutions Advisory Commission (IFIAC), headed by Prof. Allan H. Meltzer, now known as the Meltzer Commission. The Commission's core recommendation was that IMF should primarily focus on crisis prevention (crisis management, improved quality and increased quantity of public information, and macroeconomic advice to developing countries). Facilities like Poverty Reduction and Growth Fund (IMF institution established in 1999) deal with long-term lending, this should be left to the competencies of IBRD and other development banks: "If these banks did a better job, there would be no need for the PRGF", wrote Meltzer.

2) It should be noted that GINI coefficient covers relatively large groups of populations and does not clearly include the "bonuses" of social and political hierarchies, of people in certain public positions, such as members of dynasties and/or political leaders. For example, it can be said with a great deal of certainty that before 1989, my country, Bulgaria, was ruled by about 80 families (often connected and in second ranks rotating) who, grouped with members of communist party committees and government bodies, accounted for about 2.25% of the population, while the difference in income compared to the status of "the average citizens" was approximately 50 times. Similar was the situation in all countries of a similar status after 1917.

tute a combination of raising taxes and cutting government spending. Both components are considered mandatory. Complementing this mission by the required focus on poverty and inequality follows from the Meltzer Commission proposals of 2001.

Generally speaking, IMF focus on this subject is characterized by common methodological imperfections, such as:

- It considers periods of fiscal allocation when progressive taxation is practically universal in the post-war history of developed countries. Towards the end of the time period under consideration, taxation in them is equalized, "flattened" and reduced. In this case, the dynamics of inequalities, and in particular their decline, do not necessarily turn out to be related to the growth of income tax thresholds or its progressiveness.
- There is no comparison to the periods when these countries were poor, with great inequality, no income taxation, or income taxation negligibly low, temporary and in no way progressive (except for the expropriation of foreigners) and there is no tax jurisdiction in the world that has had high taxes and government spending (as a share of GDP) when it has developed from low to high levels of prosperity.

Longer historic perspective

The longer-term perspective shows that by 1920 governments (kings, sultans, etc.) had imposed much lesser taxes, and had financed far fewer public tasks (army and navy, protecting territories and maintaining government institutions and the judiciary). The tasks of modern governments are more than twenty, with a good deal of spending on social welfare, especially in developed countries.

In general, for ten years IMF research has been characterized by the assumption that governments are noble, infallible, and effective in the policies they pursue.

If these methodological imperfections are taken into account, it will turn out that, measured by poverty, inequality has, firstly, decreased almost fivefold in the last forty years and approximately nine-fold in the last 110 years, and secondly, in other ways, but it occurs when marginal tax rates are reduced, taxes are flattened and flattened, and general government spending is reduced (or overall relatively low) overall. For example, Wilhelm and Fiestas (2005) found that increasing spending to improve the situation of the relatively poor is often more beneficial to wealthier social strata.

Governments' social policies (including health and environmental protection) are funded by safer indirect taxes. When these taxes also increase (mainly in developed countries), consumption opportunities of lower-income households in individual countries decrease.

A refutation of the "growing inequality" reference is China (after 1980) and India (after 1992), and for several years now Africa, although it accounts for more than half of the world's extremely poor, measured at USD 1.90 per person per day. (See: Stanchev, 2021.)

In Bulgaria, inequality for the last thirty years has reached its lowest in 1996 and 1997, when for February 1997 the average real wage was USD 20 and the average pension USD 5, and the extremely poor (according to the same World Bank criteria) accounted for at least 37% of the population. (In 2020, the share of the extremely poor in Bulgaria was below 0.85%; less the US 1.6% of the population).

Inequality is a problem when it comes from power and privileges.

When tax laws, enforcement of contracts and protection of property rights treat and protect all taxpayers equally, inequality is rather a natural phenomenon. This problem with the fairness of income taxation was intended to be solved with the flat equal, proportional tax. The decision to proceed with such a reform in Bulgaria has been well described (see Nikolova and Ganev, 2016). When, on the contrary, by law or other acts of power, privileges are created, that discriminate against (disenfranchise) or expropriate certain people or groups, there emerges a reasonable and understandable public sense of injustice.

After 1997, Bulgaria's economy has remained in that situation, probably combined with inequality and favoritism imposed by political means. 1996 and the early 1997 were the worst periods of impoverishment in this country's history. Then came the period, which, due to misunderstanding, is often denoted as a "catching up" period. The need for income recovery after the hyperinflation of 1996 and 1997 is important if we need to provide an explanation of inequality in Bulgaria and its relative position in wealth and income indicators to other European countries. (The GINI dynamics follows the growth and recession periods of the last 30 years relatively accurately.)

From Progressive to Flat and Back

By the nature of tax systems, the idea of increasing marginal tax thresholds is fully applicable, it should be noted, makes both methodological and political sense, in the countries with progressive taxation of income taxes (personal, corporate and labor, “insurance”), not so much for proportional, equal or “flat”[3] tax treatment of incomes.

By the end of 2021 30 countries and 31 sub-national jurisdictions should be in the latter group. Among them are 23 former COMECON member states and republics of the USSR, including most of the Balkan countries and my own country – Bulgaria, and three other present EU members, Estonia, Hungary and Romania. The group of sub-national jurisdictions includes Wales, seven US states (where in five other states there are no corporate income taxes or personal income taxes),[4] two cantons in Switzerland and individual municipalities with locally determined taxes. Since 2011, sixteen countries have renounced equal taxes on income and reintroduced some form of progressive taxation, usually on “very” high incomes by some national criterion. The latter include Albania, Latvia, Lithuania, Russia, Slovakia (its reform is briefly discussed below), Serbia, Montenegro and the Czech Republic.

The general research and policy interest in flat tax reforms was very much popular in 2006–2008. The latest IMF working paper was published in 2007. In 2008, the National Bureau of Economic Research (NBER) published a very interesting working paper stating that “large and significant changes in tax evasion following the flat tax reform are associated with changes in voluntary compliance and cannot be explained by changes in tax enforcement policies”.

More recently, in July 2020, another NBER paper discussing the overall theme of Efficient Redistribution established that “flat uniform tax on income is nearly optimal in that the additional welfare gains from non-linear income and wealth taxation are small”. In the last ten years OECD’s Tax Policy Working Papers published only one report on how “Slovakia moved beyond flat tax”.

The Slovak case

In Slovakia, the flat tax reform was implemented in 2004 yet ten years later the country switched back to progressive taxation.

The reform campaign started in 1998, simultaneously with similar coordinated campaigns in Bulgaria and Poland. The Slovak campaign was more effective politically and Slovakia became the second country of the former Soviet bloc, now member of the EU, after Estonia, to introduce an equal tax. The prime motivation, as explained by a finance ministry official was to create a tax system that was “light, non-distortive, simple and transparent.” An important reform motivator was the need to consolidate the public finances in the view of Slovakia’s accession to EU in May 2004. Prior to the reform the country had five personal income tax rates of 10, 20, 28, 35 and 38%, while the corporate income was derived from taxes at 25% and VAT rate was dual – a “standard” 20% and a “lowered” 14%.

The new applicable flat rate constituted 19% of corporate and personal income, and so did unified VAT, also 19%. Actually, the VAT rate was one of the benchmarks for determining personal income tax rate. The inheritance, dividend, real-estate-transfer and gift taxes were eliminated altogether. The immediate effect on public finance was positive: the government spending was rationalized (decreasing from 51% of GDP in 2000 to below 40% between 2004 and 2009 when the recession pushed the spending back to levels a notch higher than 40%), the budget deficit declined from about 8% to 3% per annum,

3) In Macedonian, “flat tax” as a term equals to “equal tax”.

4) Throughout the recent 100 years, 13 states of the USA had have, or are implementing flat income taxes, Arizona and Georgia are planning to implement such systems after 2024 (see: Walczak, 2022).

and the gross government debt was reduced from 40% to 30% of GDP.[5]

Notwithstanding the fact that the reform also involved VAT and income, it was not fully "flat" on all kinds of income tax: e.g. income at the "minimum living standard" level calculated by the government in 2004 to 80,832 Slovak kroner per year (about 162 Euros per month), was exempt and was then updated each year.

This duality of Slovak proportional tax and the way annual living standard threshold was set, played a key role in advancing political will to return the country back to progressive taxation. (At the end of 2012, even the First Global Conference on Flat Tax, held in Bratislava in defense of flat tax system (Liptakova), failed to counter that political strain).[6]

A special OECD review of Slovak tax reform story (Remeta et. al., 2015) found that "because social security contributions remained high, the overall tax burden on labor remained substantial". Tax wedge for low-income workers remained burdensome and motivated a shift from direct to indirect taxation. Other studies found that the reform did not increase incentives to work. In effect these and the business cycle factors, the overall Slovak tax-to-GDP ratio had fallen from approximately 33% in 2005 to 28% in 2012, according to OECD Revenue Statistics.

In fact, a three-tier proportional system was introduced with a non-taxable minimum of € 5,040 per year and a 25% income tax, which is 176.8 times the annual "subsistence level". In parallel, a possibility of deducting 40% of expenses was allowed, without any book-keeping but limited to EUR 5,040 per year, for self-employed workers. The corporate income rate increased from 19% to 23%, remaining "flat" (it was than reduced to 22% in 2014). For the positions of top public servants (the president, deputies, ministers and supreme judges and prosecutors), a 5% solidarity tax has been introduced, since their remuneration exceeds the average gross wage level. In general, solidarity was a key argument of the tax counter-flat-tax reform rhetoric of the then ruling political party SMER (in English – "Direction") for returning this complex system back to existence.

After 2013, tax system was subject to frequent adjustment of rates and preferential treatments, especially in social security contributions. The total tax revenue increased by 1.5 percentage points to around 30% of GDP. The OECD report quoted above concluded that: "Widening VAT, PIT and CIT gaps as a result of increased tax evasion and tax planning behaviours by households and businesses and the difficulties faced by the tax administration to tackle these issues".

Two relevant ex-communist cases

Flat tax has been considered by many EU countries. The Internet portal of the London based Institute for Fiscal Studies (IFS) provides a panoramic overview of such discussions in the UK and in Germany, while the Institute itself is no advocate of flat tax systems as such.

There are two specific cases of flat tax reforms, those of the Russian Federation and of Poland. It is worth summarizing their experience, in order to highlight different approaches to, and backgrounds of, reforms.

As noted above, different versions of flat tax systems with equal tax and non-taxable minimum were discussed in 1997–2003, jointly by private think tanks, in Bulgaria, Poland and Slovakia (see: IME, 1998). The need to deregulate the respective tax systems was duly analyzed and presented to the public in those countries.

In Poland, the idea of an introduction of equal tax rate on corporate personal incomes was given up with the resignation of then Finance Minister, Leszek Balcerowicz, in June 2000 as he was one of its main, although not very vocal, supporters. However, the Warsaw Institute of Private Entrepreneurship Democracy (IPED), an affiliate of the Polish Chamber of Commerce, the largest Polish business representative organization, had switched to its own less ambitious advocacy of flat tax on corporate income.

The IPED argumentation strategy was not purely academic by nature; rather, it was policy oriented. At that time, the road to full EU membership was associated, in Poland as well as in all other candidate countries, with not yet known but presumably higher compliance costs of operating a business.

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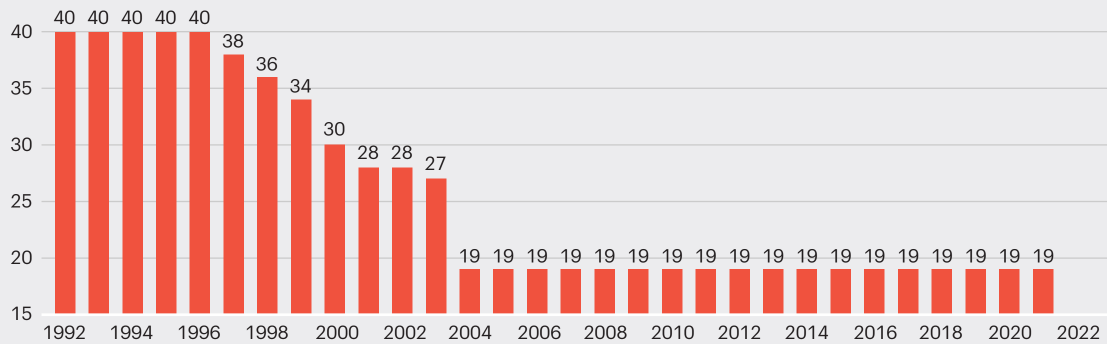
5) After 2009, gross government debt increased and fluctuates at 50% of GDP level coinciding with the accession to the Eurozone and the global recession.

6) The conference included as participants Alvin Rabushka who, together with Robert Hall, designed the USA flat tax blueprint, as well other flat tax reformers from Eastern Europe, see: The 1st Global Flat Tax Forum, October 4–5, 2012, Bratislava, Slovakia: https://www.hayek.sk/conference-the-1st-global-flat-tax-forum/.

Figure 1. **Poland's nominal tax rates on income from business activity and capital gains in the last 30 years**



The overall expectation of such costs turned out to be the main political motivator for the 2004 tax reform: a relatively low "flat" tax of 19% on corporate income. The experience with previous reductions of the corporate rate were also helpful.

For top corporate tax payers marginal tax rate fell from 40% to 19% at the cost of giving up tax preferences (broadening the base) from previously applicable three-threshold progressive ladder of 19%, 30% and 40%.

Businesses, large and small alike, had taken this opportunity to restructure operations and seek comparative advantages. A study of the effects by Kopczuk (2010) found that "the reform provides an opportunity to exploit difference-in-difference strategies relying on differential benefits from the reform among otherwise similar individuals." A "side" motivator was the taxation on personal incomes whose higher nominal rate at the time of the corporate tax reform was 40% (reduced to 32%, and with a lower rate of 17% in 2012).

The overall outcome, Kopczuk found, was the reduction of tax avoidance or of involvement in grey economy. In the last eight years, taxation preferences had been introduced for young employees, small businesses, etc. but in 2019–2021 the revenue statistics suggested that Poland's corporate taxes remained the most important source of government revenue. Its share in revenues was as high as in Germany, Slovakia, Slovenia and Spain, between 37% and 42% of the total taxes collected.

The case of Russia's flat tax system and the return to a progressive taxation have remained special in many respects.

It was the case of a large country about to introduce a 13% tax treatment of personal income in 2001. Its approach was different from that of Poland because Russia applied flat rates on different tax types: 20% in the case of corporate tax (30% in 2001 and 24% between 2002 and 2008), 30% for social security taxes, 30% as dividend tax and 5% as municipal corporate income tax. (The lowest brackets of income were tax exempted from the 13% rate, a situation, which changed with time but remained roughly at the level of 12% of the average gross salary.) In other words, Russian tax reform was one of multiple flat taxes, with substantial differences between rates and with two effective personal income tax rates of 0%, and of 13%, while levies on personal income had never been a prime source of revenue for the government.

In 2002, single marginal rate made real revenue from personal income taxes increase by about 26%. Different studies, however, found little correlation between, and limited causality effects of, the reforms and fiscal performance in the Russian Federation. On the one hand, the reform coincided with the period of robust economic recovery after the 1998 government default that boosted export and investment, especially FDI. On the other hand, the IMF study (Ivanova et al., 2005) found that "the experience of individuals and households affected by the reform to varying degrees" (probably due to the different "tax optimization options" opened to them), and that, despite the fact that overall compliance improved by about one third, "it remains unclear whether this was due to the parametric tax reform or to accompanying changes in enforcement." Again, the economic

recovery and growing exports spoke of substantial fiscal surpluses, while, oil and natural gas revenues discounted, the "net" budget balance had remained negative, averaging at the level of –6% (from 1998 to 2012 according to OECD (2013, p.6) estimates). This was the reason to amend Russia's Fiscal code in 2013, imposing a limit on the non-oil deficit of the federal government equivalent to –4.7% of GDP (a limit that was basically preserved).[7]

Switching back to the progressive system was announced by President Putin in mid-2020: the main argument was social "solidarity" of high income earners, amidst the negative impact of COVID-19. As of January 1, 2021 annual individual income of over USD 67,000 was to be taxed at 15%. The new tax did discreetly improve budget revenue from personal income taxes for the year by USD 1.1 bln, half of it paid by residents of Moscow. Government spending for the same year was USD 645 bln. In terms of budget revenue or spending, introduction of second nominal rate did not seem a particularly radical or effective measure.

7) This study (p. 4–5) and other sources prove that the economy (and particularly the economic growth) of the Russian Federation depends on oil prices. The business cycle story of Russia demonstrates a broader benefit from the openness to, and the integration with, world economy: GDP in current prices grew from USD 287.7 bln in 1998 to 2.29 trln in 2012 (the highest point ever), than, according to the statistical portal CountryEconomy.com, the indicator went down to USD 1.48 trln in 2020. Owing to the growth of oil export revenues in 2018 and 2021 (by about 41%, reaching its highest level since 2006), the GDP of 2021 went up to USD 1.78 trln.

Relevant history lessons

In the present work, modern history of the theoretical reflection of taxes on income and its policy application are discussed. Pre-modern times were dealing with similar issues and, as it had been demonstrated by taxation historians (see Seligman, 1894), property taxes in Ancient Greece and Medieval Europe might be interpreted as precursors of income taxation since they were levied on the product produced by a given property (most often land); modern governments however had increasingly used monetary expression of income to evaluate and measure the tax.

This is the relevant experience from the second half of the 19 c. to the present day.

"Old England" and the 19 c. debate on just taxation

As early as in the middle of 19 c. (Mill, 1848), reasonable doubts were raised on the possible social and economic effects of progressive income taxation. "It is said, wrote John Stuart Mill, that the proportional tax rule has a greater negative impact on the moderate than on the high income, as in the first case it has a stronger tendency than in the second, it tends to put pressure on the payer, or to a lower social rank. This statement seems more than doubtful to me." In "On the General Principles of Taxation",[8] Mill commented on the question of fairness and equality in taxation as follows:

"The subjects of every state ought to contribute to the support of the government, as nearly as possible in proportion to their respective abilities: that is, in proportion to the revenue which they respectively enjoy under the protection of the state. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation."

In other words, justice has two sides: equality before the tax law and a requirement that citizens ought to be given the opportunity of enjoying their income prior to tax contributing to the treasury.

Mill's principles are taxation requirements which have not changed much for a period of more than 170 years and which are worth mentioning, because they may also serve as a contemporary criterion for the evaluation of the effectiveness of tax systems applied by the OECD (2019).

According to Mill, a tax system is fair and efficient when:

1. "Takes as little out of your pocket" (leave as much disposable income) as possible;
2. Taxes are clear, predictable and convenient to pay;
3. Penalties for non-payment are bearable and do not ruin the taxpayer;
4. Inspections by the tax authorities shall be as infrequent and unobtrusive as possible.[9]

When Mill formulated those principles, a personal and corporate income tax had recently been introduced in England. That happened in 1842, and the tax was same for everyone –5%. Earlier, in 1799, an attempt had been made to introduce an income tax of 2% and 10%, but it was repealed as ineffective and unfair. The amount raised was 40% less than needed for a war with France of Napoleon. A 10% tax was required from citizens of a very high income because they were supposed to be more interested beneficiaries in the government's "national security" benefit.

In 1842 the reason to introduce the 5% tax was a compensation for the elimination and the reduction of, some protective custom tariffs, with the intention of levying the tax for three years. The effect was that the new tax

8) Published in Book V, Chapter II of "Principles of Political Economy with Some of Their Applications to Social Philosophy".

9) Here Mill echoes the observation by Adam Smith (1755), recorded from ethics lectures in 1755, that almost nothing else was needed to "ensure the highest degree of abundance but peace, easy taxes, and tolerable administration of justice .... everything else will arise the natural course of events".

raised government revenue and, respectively, spending, by only 0.16% of GDP in just the first year of the new tax regime. Under various pretexts (financing the railways, the Crimean War, etc.) the tax had remained in force for 25 years, although it did not provide the expected revenue and despite the fact that most leading politicians (during this period Benjamin Disraeli and William Gladstone were Prime Ministers) promised to abolish that particular type of tax. Apart from the period of the two wars in Mill's homeland, during that first half of the 19 c. (see: Hartwell), tax revenues ranged between 9% and 11.5% of the national income per capita.

Cohen Stuart on "Progressive Taxation"

In 1889, the Dutch economist and politician Arnold Jacob Cohen Stuart (1855–1921) came up with criticism, perhaps the first based on mathematical considerations, of Mill's understanding of just (and flat) taxation, thus becoming pioneer of the contemporary idea of optimal taxation (see: Stuart, 1967). If Mill assumed that tax justice took place when each taxpayer made equal contribution (or "sacrifice", in the slang of the time), Cohen Stuart believed that individual sacrifice should not be equal absolutely but should be assessed as a share of the "total satisfaction" each individual derived from his income. In Stuart's own argument:

> "The underlying reasoning may be expressed in even simpler terms: the person who has an income of 10,000 has not only ten times as much money as the person with an income of 1,000, but in addition the money out of which taxes are paid has less value for the former than for the latter. It is not sufficient that the former simply pay ten times as much money.
>
> This conclusion would undoubtedly be correct if an income ten times larger than another yielded total enjoyment ten times greater, while an equal percentage of both incomes entailed a sacrifice of less than ten times the enjoyment for the recipient of the larger income. To express it more precisely: the conclusion would be correct if the subjective value of the last income increment necessarily decreased faster than the average subjective value of the entire income."

In other words, according to Stuart, the utility curve for individual taxpayers is not "flat" and it is just a mathematical task to define the subjective individual rates of enjoyment and tax contributions. The utility is decreasing with raising incomes, hence just taxation would require a "progression", he concluded.

In a sense, the discussion had not been resolved with any finality for a period of 130 years. What had changed, however, from the times of Cohen Stuart's defense of taxation progressivity was the fact that progressive income tax rates were several times higher than the rates he used in his calculations. Believing that there was a non-taxable minimum of income, he compiled tables (see, Stuart, p.71) to demonstrate the difference in individual enjoyment, using different "steps" of progressivity (from 100, to 500, 1,000, etc. to 500,000 units of currency) and rates from 1 to not more than 7–8%. From a contemporary perspective, it is unlikely that the debate would ever existed had the applicable nominal rates been on this level.

USA and the Scandinavian countries

The story is roughly similar to that of the UK: in the 19 c. a personal income tax of 2% and 7% was introduced to fund 1/15 of the Union's spending on the war with the Confederation of Southern States. (The envisaged revenue was not collected, and the war effort was eventually financed by the federal government borrowing of USD 300 million.)

Eventually, federal income tax was imposed on corporations in 1909 and on personal income in 1913. For this entire period (again excluding wartime taxes), federal government spending remained generally below 5% of GDP.

100 years after the introduction of progressive income taxation in the United States, it looks more progressive than the effective marginal tax rates in the Scandinavian countries.

At the same time, the OECD inequality statistics demonstrates that in the USA the latest GINI coefficient is 0.395 while in Norway, Denmark and Sweden, it is 0.261, 0.263 and 0.280 respectively. Presumably, there are several explanations related to tax and redistribution policies:

- High taxes are not paid as prescribed by nominal rates; many costs are eligible for reduction of taxable income and the list of tax preferences had been constantly enlarged since the 1920s;
- Preserved tax competition between the individual states and the richest and most competitive companies operates through jurisdic-

tions with low taxes and secure payment systems in the United States or abroad;

- There is no income tax in many of the US states (e.g.Florida, Texas, South Dakota, Washington and others);
- The redistribution via different federal and local social welfare schemes is less effective in keeping the GINI rates at lower levels.

Wicksell's just taxation

On the level of philosophy it may be argued that countries with high GINI coefficient do not comply with Knut Wicksell's "principle of just taxation".

In Wicksell's (see 1967) understanding social justice is a complex phenomenon of tradeoffs between distribution of opportunities and wealth, and legal (and fiscal) guarantees that each individual received enjoyment corresponding to the sacrifice of his portion of income. Since, according to Wicksell, the enjoyment or benefit for a society is based on individual utilities, "no one can judge this better, than individuals themselves or those who represent their inter legislation". With a great degree of simplification, one can assume that a Wicksellian just taxation is one that is based on, first, sufficient evidence on individual benefits from overall taxation (and redistribution) known in principle to the individual voter and, second, on his or her consent with the actual outcome of the tradeoff between economic and social justice.[10]

Sweden in a comparative perspective

Sweden is one of the countries, which introduced income taxation relatively early, the latter being in place since 1862. Its overall tax history presents a confirmation of the general rule that steep progressive taxation and high government spending do not emerge in a "poor" country.

According to Stenkula (2014), until 1932 (including the period of neutrality during the First World War) the upper limit of taxes in GDP did not exceed 10% and average tax collected was about 7%. For the same period and the upper limit of income tax on the average even today (Assen, 2021) the revenues from direct income taxes in the budgets of Norway and Sweden amount to 10–12%; what with the social taxes there and in Denmark, there is in fact an almost flat tax of just over 20%.

In the last four or five years (the latest comparative statics available is for 2020), Sweden's OECD measured Composite Effective Average Tax Rate and Composite Effective Marginal Tax Rate fluctuate between 20 and 21% and 13–13.5%.[11]

In Sweden, Denmark and the USA, budget revenues from corporate taxation measure about 3%, approximately the same as in Bulgaria.

Sweden's wealth can be explained largely by the early introduction of appropriate and just institution. According to Berg (2011), the following rules of the game were (and remain) in effect:

- the rules of ownership and use of land were established in the middle of the seventeenth century (and had not been violated since then);
- since 1842 primary school education had been compulsory;
- in 1845, aristocratic privileges for public office posts were abolished, the rights of all heirs were equalized regardless of their gender, and censorship was abolished;
- again at that time, the privileges of the guilds in education were abolished, rules for the registration of joint-stock companies were adopted (remaining generally unchanged since 1848);
- And in 1850–1860, trade was almost completely liberated (violation of this freedom was forbidden as from 1864).

Taxes on wealth

From 1990 to 2017, the number of OECD member countries with special taxation of the rich decreased from 12 to 4: Switzerland, Spain, France and Norway, out of all 37 OECD members. After 1980, the minimum statutory income rate in the OECD fell from 47% to 15%. More important (OECD, 2018) is however the effect of taxing the "rich" in the individual member states. The tax on the rich in Switzerland is 1% of GDP and 3.7% of all tax revenues. Also, Switzerland is the only country showing a tendency for a slight increase in revenues from this tax after 1980.

10) See more on this in Johnson (2010)

11) See statistics at OECD, Effective Tax Rates: https://stats.oecd.org/Index.aspx?DataSetCode=CTS_ETR

This specific index may be considered a success, because in Spain, for instance, the ratios are 0.18% and 0.54%, in France, respectively, 0.22% and 0.48% and in Norway 0.43% and 1.3%, while and everywhere else in the OECD their share in the economy is declining.

This is not just a pattern for the rich OECD countries. In 1957, India introduced a 2% tax for rich taxpayers, but for the entire period until 2015 (when it was abolished) it proved completely inefficient in its fight against social inequality. Nowadays, this inequality is declining not only in India but globally, as shown by all detailed statistic reviews (see: Tupy, 2018).[12] Simultaneously, poverty is shown to have decreased substantially (regardless of the statistical method used to measure it) since 1992, arguably due to policies liberalizing economic life and the resulting economic growth.

In the past 20 years, the overall system of income taxation had not changed significantly: the lowest bracket of income had been tax exempt, with four nominal thresholds, and it is 37% for the highest category. Also in the past twenty years, the group of the extremely poor (according to the international measure of USD 1.9 per person per day) shrank from 40% down to 1.5% of the population in 2019 (see Bhalla et. al., 2022). Currently, India discusses the possibility of an annual 2% tax on wealth over USD 5 mln, 3% on wealth over USD 50 mln and 5% on wealth over USD 1 bln. In the press, the measure is justified by counting billionaires: India witnessed the emergence of 55 new billionaires in 2020, and it is believed that even if it is applied as a temporary measure, the one-off tax on the richest will compensate for some of the negative consequences of COVID-19 on poverty.

The lessons

As in the 19 c. England, as well as in the United States, Switzerland and India, and also in Slovakia after 2013, taxing the rich did not yield visible results. After 2013, the increase in revenue from this tax was 0.84% of GDP, according to OECD tax statistics, that is, twice lower than the average share of income taxes on GDP in member countries.

The main problem is the transfer of ownership of part of the income to tax authorities, the total amount of which is channeled to finance activities on behalf of all. As is known from Wicksell, "benefit for all" is not easy to observe by any of the individual members of any society and it is equally difficult to be appreciated by the voters in any representative democracy. In all such actions, regardless of the system of taxation, a familiar "free-riding problem" arises between different groups of taxpayers.

At macro level, this situation is very likely to be perceived as definition of "the State", i.e. as an entity through which everyone seeks to live at the expense of somebody else, a concept which appeared in mid-19 c. and belonged to Frederic Bastiat.

What is interesting, is that the entire theoretical debate on progressive or proportional taxation, on optimal taxation and the elasticity of taxing income or the contribution of tax policies to reduction of vertical income inequality, pays little to the history lessons as listed below:

1. Countries should become rich without such taxes. There is practically no country of those who today consider themselves developed and rich that has reached this position owing to income tax, especially high income tax. Progressive tax systems have remained relatively unchanged after 1920. But in 1920, those countries were, on the average, four times richer in GDP per capita than, for example, the East European countries; as well as six or seven time richer than the rest of the world
2. Alongside the reduction of taxes and abolition of taxation of the rich, national wealth is increasing for the average adult population. At the same time, irrespective of the personal income tax reforms in different OECD member states, and despite technological progress and digitalization of tax payments and controls, the average level of personal income tax revenues has remained unchanged as percentage of GDP since 2000; it was 8.7% in 2019 accounting for 8.04% of GDP.
3. Despite the nominally high, costly and progressive corporate income tax schemes, marginal efficiency of taxation in the richest (G-7) countries has remained the same as in countries with simpler, more convenient and effective tax systems. This is well demonstrated by the OECD statistics on effective marginal tax rates on corporate income in 2018.

12) The author has summarized the statistical analysis of Angus Deaton and Branko Milanovic. For the international policy context, see also: Stanchev (2021) and Stanchev and Popovski (2021).

Table 1. **G-7 composite effective tax rates (2018)**

Country	Composite Effective Tax Rate	Composite Effective Marginal Tax Rate
Canada	24.6	10.5
France	30.3	16.7
Germany	27.5	11.5
Italy	20.7	–56.3*
Japan	27.2	8.2
UK	18.4	13.6
USA	24.6	11.2

Source: OECD.

* Tax not corrected

4. G-7 and many other government leaders are intentionally ignoring the lessons from their own countries' tax experience:

   a. In most of them, income taxes and especially progressive tax systems were imposed to finance wars or under the pretence of financing post-war recovery.

   b. More important, however, is capital formation: higher taxes will diminish its pace. According to Credit Suisses latest Global Wealth Report (where wealth is measured according to the market prices of the assets owned by governments, corporations and adult individuals), in 2019 North America proved 27 times wealthier than Africa (where the growth rate is 14% a year), 1.5 times richer compared to China, and 7.8 times richer than India. EU's wealth accounts for 76.1% of that of North America. Higher taxes in the EU, higher levels of government debt to GDP, and high compliance costs will have a negative impact on capital formation in less affluent parts of the globe and in the Central and East European member states.

   c. Except for China, the so-called rich countries are the ultimate creditor of the rest of the world: their proposals for higher taxes are likely to make other countries more dependent on aid and credit from G-7, Europe and China. China itself is allegedly the largest lender to developing countries (see Horn et. al., 2020). A higher global corporate tax, irrespectively to whom it applies, is doomed to worsen the indebtedness of poorer countries.

   d. Today, the G-7 bloc is more than three times richer than the world average, the average values of GDP per capita in ¾ of the world countries are comparable to those before the introduction of corporate, subsistence and progressive taxation in the G-7. In other words, these countries are effectively denied the growth opportunity the richest countries enjoyed when they were less prosperous.

The initiatives to increase corporate taxation contradicts the last 30 years tendency for lesser government revenues from this source in the richest countries and cannot help sizable government debts of these countries.

Table 2. **Corporate tax revenue and gross government debt in G-7 countries and Bulgaria (1990–2017)**

Country	Corporate tax revenue (% of GDP)	Government debt (% 2017 GDP)
Canada	2.5–3.7	89.7
France	2.2–2.3	98.5
Germany	1.7–2.0	64.1
Italy	3.7–2.1	131.2
Japan	6.3–3.7	223.8
UK	3.3–2.8	87.0
USA	2.0–1.7	82.3
OECD (average)	2.5–3.0	89.7
Bulgaria	3.1*–2.2	22.0

*1995.

Source: OECD.

"Regressive taxation"

One of the main criticisms of the equal tax is that it was "regressive", i. e. a tax that is applied equally to people with different incomes is more burdensome for those with lower incomes than for those with higher incomes.

However, as this is not the only tax but is combined with taxes that are also fixed, the

amount of taxes due always turns out to be heavier for those with lower incomes. For example, when food costs account for 29.6% of total costs (as it was in 2020 Bulgaria), VAT actually weighs more on incomes at or below the average. The same goes for excise duties, property taxes, state fees, etc.

The advantage of an equal tax is that the taxpayer has some control over his diet, knowledge and skills, competitiveness; and that in general terms he/she knows what to do next and can invest to change his/her income upwards, according to his/her own subjective (and basically unknown to others) preferences. All other things being equal, this is an affordable and behavioral way to reduce the burden of all tax payments per unit of income.[13]

The statistics of indirect tax revenues by items of consumption shows that in flat tax jurisdictions, their share in total revenues is somewhat more significant than direct taxes. This does not necessarily affect redistribution via welfare transfers. As the 2021 Index of Tax Burden on Global Workers shows: "Flat tax regimes impose a fixed rate on income tax, but not other taxes: social security rates in flat tax countries are, on average, higher than in progressive states; social contributions make up for 77.6% of payroll taxes collected in flat tax countries (versus 65.9% in progressive systems)". (See: Rogers and Marques, 2021).

The OECD statistics on member states' tax wedges reveals another regularity. The average tax wedge from 2000 to 2021 narrowed from 36.2% to 34.6%, in Estonia from 41.3% to 38.5% – roughly by the same rate but from a higher level. The outlier in OECD in this indicator from EU member states is Hungary: the wedge shrank from 54.7% to 43.1% (remaining above the average). Similar is the story of Sweden – decline from 50.1% to 42.6%.

This leads to a high average tax wedge of 43% on labor income.

The common pattern in EU/OECD members that attempted flat tax is that in the years they had registered narrowing of the tax wedge but upon returning to some form of progressive taxation of income, the tax wages grew up to above average OECD levels. Alternatively, the Polish example is that with flat rate only on corporate income the tax wedge declined from 40% in 2006 to 34.9% in 2021.

The effect would be similar in jurisdictions with multiple flat taxes, as, for instance, Russia, where revenue from other taxes may compensate the overall budget deficit or finance welfare and social aid policies.

Alternatively, in progressive tax jurisdictions, the policy option may be that authorities impose the low combined social security taxes but the treasury is compensated by the highest personal income tax rates. (This is the case of Denmark, which imposes the lowest social security contribution in the EU).

In terms of regressiveness, a flat tax system with no non-taxable "floor", like the one in Bulgaria, is by and large free of need to address annual and/or cyclical dynamics of the gross income. The concept of "elasticity of taxable income" is also not applicable to the narrow segment of personal or corporate income taxation.

13) This is a phenomenon of an always available "individual tax arbitration" that utilizes option for individual savings from different tax obligations and payments, or invest efforts to improve own income. One of the weaknesses of the above discussed Cohen Stuart's "On Progressive Taxation" is that its mathematical modeling cannot take such "arbitration" into account.

Wealth of Nations: The Experience of Bulgaria and of other countries[14]

Prior to flat tax reform

The gradual reduction, and the simplification of Bulgaria's tax system was motivated by two deep economic recessions in the early- and mid-1990's.

In the fall of 1994, when the Socialist Party won the elections following a relatively successful launch of reforms, it implemented a policy of "regulated market transition", choosing to support non-privatized public sector enterprises. Those were therefore ordered not to repay credits to banks; price controls were reinstalled by the end of 1995, shortages of main consumer goods reappeared, and after April 1996 the country was already a global "leader"[15] in hyperinflation and headed the negative ranks of countries in transition in terms of the most costly banking crises in 1996–1997 of 41.6% of GDP (Tang et. al., 2002).[16] Solution was arrived at through new elections and a fresh start of transition reforms in 1997.

Other countries in Central Europe had already restored their pre-1990 levels of GDP per capita by 1995–1996, when Bulgaria's government renewed its attempts to prolong central planning. In fiscal area the emphasis was on high direct taxes, and on steep progressive income taxation in particular. For instance, the tax code of 1993 applied a scale of nine different nominal rates, from 20% and 52%, plus a high social security contribution; corporate income was taxed at four rates, up to 40% and there was a 10% municipal tax. Tax system was also used to deal with additional vertical equality targets with a "tax on the growth of salary funds" that was also believed to be an appropriate anti-inflationary measure.

In early 1997, the rate of profit tax was 40%, income was taxed at rates between 20% and 40%; social security contributions were 44%; VAT was 22% and excise duties were imposed with some significant effect only on fuels (excise duties on alcoholic beverages and tobacco product were either not paid, or those articles were produced at home or illegally).

Following the reform

Since 1998, Bulgaria had experienced the longest period of economic recovery growth in its entire history after 1878. It was interrupted by a short-lived, 13-month long recession in 2009. The population restored the savings that it had lost through hyperinflation: the private savings to GDP ratio in 1995 was 52%; in the spring of 1997 this dropped to 11% of GDP; in the first quarter of 2022 they accounted for almost 68% of GDP. Privatization of SOE and banks was finalized by 2004. For the years of Bulgaria data in the Global Wealth report of Credit Suisse, the average economic growth in GDP for the 1998–2008 period was 5.2% per annum, in 2011–2021 – 2.8% of GDP.

Unlike GDP, the wealth indicator gives an idea of market value the assets owned by adult citizens of a country both as finance and as capital, and as a real estate and movable property.

In 2000, after restructuring and reduction of taxes began in Bulgaria in the spirit of Mill's principles, the average wealth of an adult citizen of the country was 3,839 USD, and in 2010, 42,685 USD. This constituted an increase of 1,111.88% (with a registered decline in 2009 and 2010). There is no other country with such an increase in national wealth in the OECD or Europe during that period. However, no clear cut causality effect between the introduction of the flat tax and wealth dynamics and/or the performance of the economy has been established.

The low starting point has been one of the reasons for the remarkable growth of wealth in Bulgaria. Business cycle, conjectural and demographic factors have also been operating. The country started negotiations for EU accession in

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14) Some of the estimates in this section are from the co-authored book on Flat Tax in Bulgaria (Nikolova and Ganev, 2016).

15) See Hanke-Krus Hyperinflation Table.

16) For different reasons, other countries, too, experienced bank bankruptcies that led to sizable fiscal losses, e.g. Czech Republic –25.4%, Hungary –12.9% and Macedonia – 30.3% of GDP.

1999 and joined the Union in 2007. Before that, in 2004, it become NATO member. Owing to the promising prospects (and also to domestic progress in observing the rule of law, and to privatization and business environment reforms), between 2005 and 2008 Bulgaria ranked first in the world (after Hong Kong) in terms of FDI inflow relative to GDP (this, according to UNCTAD 2008 FDI Performance Index [UNCTAD 2008:13]).

As an aftermath of the recession, the adult population after 2000 decreased significantly. However (Credit Suisse, 2000) these factors wealth in 2006 was USD 14.6 thousand per an adult citizen of Bulgaria, and in 2007 (the year of flattening and reduction of corporate tax) –20.4 thousand USD.

The rapid growth of wealth does not mean that Bulgaria is ahead of other countries: the average wealth for Europe in 2019 was 154 thousand USD. For Austria it was 275 thousand USD, for Slovenia –122.5; other countries rank as follows: Greece –96.1, Estonia –78.5, Slovakia –66.2 Czech Republic –64.7, Croatia –62.2, Poland –57.9, Montenegro –53.5, Hungary –44.3 and Romania –43.1 thousand USD.

The wealth in any of these countries, Bulgaria included, has not been "rightly" or evenly distributed. Comparison only points out that in Bulgaria wealth still remains fragile and that it would be quite risky to change the flat tax upwards and to introduce elements differentiation of tax thresholds.

Background of the reform

By the time Bulgaria introduced its proportional taxes on corporate income in 2007 and on personal income in 2008, a number of ex-Communist countries already had such systems in place. The following table gives the picture before 2007.

Table 3. Flat tax reforms in Eastern Europe implemented before Bulgaria

Reform year	Country	Personal Income	Corporate	Social contributions
1994	Estonia	24% (20% 2007)	0% on re-invested profits/20%	33.5 + 1%*
1994	Lithuania	33% (15% 2008–2018)	15%	31 + 3%
1997	Latvia	25%	19% (reduced to 15)	24.09+9%
2000	Russia	13%	24%	28.2% (min)
2003	Serbia and Montenegro	14%	10%	17.9 + 17.9%
2004	Slovakia	19%	19%	34.4 + 13.4%
2004	Ukraine**	13% (reduced to 15)	25%	36.8 + 3.5%
2004	Georgia***	12% (lifted to 20%)	20% (reduced to 15%)	20%
2005	Romania	16%	16%	33.5 + 17%

* "+"indicated additional compulsory pension insurance, typically in private pension funds and for younger generation.

** Ukraine's current personal income tax is 19.5%, of which 18% is the income tax and 1.5% is the military tax introduced in 2014.

*** Originally, in 2004 the rate was fixed at 20%, then for three years was reduced to 12% but, in 2008, in response to the Russia war on Georgia it was raised to 25%, the current rate of 20% remains unchanged since 2009. The corporate rate was 20% from 2004 to 2007, the rate of 15% was fixed since 2008. In 2011, Georgian legislators adopted a constitutional law On Economic Freedom (Georgia, 2011) that requires a referendum in order to introduce new taxes (except for excise duties) and limits the government spending to 30% of GDP.

The experience of other ex-Communist countries has been, on the overall, positive.

Bulgaria started planning the reform in 1997, in the aftermath of the above-mentioned crisis and as an initiative of the private think tank, the Institute for Market economics in cooperation with think-tanks in Slovakia and Poland.

By that time, in 1997, Latvia introduced a flat rate of 25% on personal income tax and corporate tax. Economic growth accelerated from 3.8% in 1996 to 8.3% in 1997. In 2004, Slovakia introduced a flat rate of 19% on personal income tax and corporate tax and the economic growth increased from 4.2% in 2003 to 5.4% in 2004. In 2005, Georgia introduced a flat 12% personal income tax and a 20% corporate tax rate, and in 2005, Georgia's economy grew by 9.3%. In 2001, Russia introduced a flat 13% personal income tax. During the year of the reform, a budget surplus of 2.7% was effected.

In Estonia, the flat income tax is now 20% but equally important was the Zero-tax on reinvested profit. This reform remained unique for Estonia, although it was advocated in Bulgaria, Ukraine and other countries. After the introduction of the Zero-tax in 2000 the amount of reinvested profit increased almost twelve time for the from 1999 to 2004 (see statistics in Angelov).

As mentioned above, some of these countries reformed back to progressive taxation. Currently, non-EU ex-Communist countries that apply flat taxes on income are: Armenia –21%, Belarus –13%, Bosnia and Herzegovina –10%, Georgia –20%, Kazakhstan –10%, Kyrgyzstan –10%, Moldova –12%, Mongolia –10%, North Macedonia –10%, Serbia –10%, Tajikistan –12%, Turkmenistan –10%, and Ukraine –19.5%.

Simultaneously with the campaign and reforms in Bulgaria, Albania planned an introduction of 10% flat tax in 2008, and 15% tax on incomes were scheduled to be implemented in the Czech Republic after 2009. An important detail is that some countries with flat taxes plan to reduce the rate in the coming years.

The common pattern was that none of them had ever attempted radical lowering and simplification of taxes on labor, or social security contributions.

Campaign, design and peculiarities of Bulgarian reform (1998–2008)

The original version of the flat tax with a non-taxable minimum was discussed in 1997–2003, as noted above, jointly with a similar initiative in Slovakia and Poland (see: IME, 1998).

The three think tanks in the heart of the reforms (the Institute for Liberal Studies in Slovakia, the Institute for Market Economics from Bulgaria and the Institute for Private Enterprise and Democracy from Poland), launched a joint campaign entitled "Needs for Deregulation of the Tax System". They believed that their respective country economy should deal away with non-trivial challenges to competition, banking sectors and public finance on the path of integration with European and global markets. The public policy objectives, they agreed, were as follows:

- Simplification of the tax system;
- Equalizing the disparities between taxes paid by individual groups of taxpayers;
- Restriction or elimination of the flexibility of decisions on tax issues;
- Limitation of tax allowances, exemptions and other exceptions to the rule of the general character of the taxation system.

The idea of overall flattening of income taxes was given up early.

In 1998, the Slovak colleagues Juraj Renzko (from the Institute for Liberal Studies) and Jan Oravec (from the Hayek Foundation) presented their idea for reform to the relevant parliamentary committee. However, it was immediately blocked by the politicians active in that period. To make the plan a reality, Jan Oravec organized a Union of Taxpayers to advocate for a change through convincing politicians and the public at large.

In Bulgaria, a representative public opinion poll by IME found that 30% of business owners prefer a progressive tax with seven tax thresholds, 25% – opted for five "rates" (i.e. the de facto for the system of 1998), 19% considered it possible and necessary to introduce a two-step progressive taxation system and 25% supported a single threshold for all income categories. On the other hand, 50% of respondents wanted tax incentives and discounts.

Obviously, a longer term of an advocacy for reform was need. Oravecs idea to proceed via an NGO of taxpayers did not take off either. The campaign took more than ten years.

The idea won in our country due to the persistent persuasion, supported by arguments, each of which was subject to comment and refutation. The original 1998 reform goals were fur-

ther elaborated to achieve the following feature of the new system.

- **Simplification**: from 1990 to 2007 the five laws governing direct taxation have become very complex; in 2007 they consisted of 180 thousand words and were amended 84 times; during the hyperinflation of 1996 – early 1997, the tax regulations were amended, on the average, 17 times per month (most often by executive orders of the finance minister of the prime minister, and were frequently amended before being published in the State Gazette).
- **Proportionality and equality**: social justice was understood in Wicksellian sense, as an equality before the law and as an equal economic opportunity. The latter was planned to be achieved by broadening the tax base and increasing the amount of disposable income for all categories of income, and by raising the budget revenue through better and voluntary compliance.
- **Social acceptability**: the reform shall be designed to sustain and, if possible, to improve the ability of the government to provide welfare services.

Building on the experience of the others, the original idea of not reforming taxes on labor was given up. The intention was to apply equally nominal rates to all pillars of income taxation – personal and corporate income, and social contributions.

The 10% threshold was determined by two sets of analysis: a) it was found that the effective tax paid by taxpayers for the period of 1990–2000 was between 12 and 13%, and b) a study of the price for tax avoidance mechanisms (forged invoices, misreporting of income, etc.) accounted for approximately 10% of saved income. Hence, the plan received a more exact form – no non-taxable income and a 10% tax on all pillars of income taxation.

The advocacy pattern was unique for Bulgaria: besides publishing a monthly called "Flat Tax" mailed to all members of parliament and collecting signatures from professionals in economy, calculation of Tax Freedom Days, etc., since 2002 IME started a compilation of its own Alternative State Budget for the following year.

The alternative IME budgets had always been balanced (or with a surplus), never imposed risks on social welfare, pension or healthcare policies but proposed modifications to improve them, and were always balancing the budget at 10% tax on corporate and personal income. (The proposal for 10% social contribution was not accepted, the alternative budget after 2008 did not apply this rate.)

From 1997–2001 the wedge between maximum and minimum marginal tax rate on personal income gradually narrowed: the five rates were reduced to, firstly, three and then two, from 1997 to 2000 the top rate was 40%, in 2001 it was 38%, and down to 29% for 2002–2004, ending with a 24% by 2008. The lower marginal rate was gradually reduced to 10% (in 2002–2005), then pushed back up to 20% until 2008.

Corporate tax reforms were opposed by IMF but the top rates were constantly reduced from 40.2% in 1997, by 2.5–4% annually. In 2004, the rate was unified to 19.5% (following the Slovak example) and then reduced to 15% in 2005–2006.

2006 was the year to lower social security burden on labor: the reduction was very significant, 6 percentage points, from 42.7% to 36.7% but had no negative effect on labor tax revenues; planned deficit of more than 6% did not materialize and there was even surplus. (The reform was supported by the EU Commission and IMF as pro-competitive and pro-compliance measure.)

2007 profit tax revenue jumped up by 39% compared with the previous year and was 27% above the budgetary projections.

This experience allowed for an income profit tax reduction to 10% as from the beginning of 2008. Two prime motives were at play – socialist majority pursued an opportunity for higher budget revenues to finance welfare redistribution, and it was believed that larger disposable income would prevent emigration and may encourage a return migration.

Effects on public finance and welfare

Besides the above discussed cyclical reason for the wealth and effects on FDI, the flat tax reform had some immediate and longer term impact on welfare and on public finance.

Fiscal surpluses had been registered for the most of the years after 1998. This allowed for a relatively fast reduction of the gross government's foreign debt of approximately 90% of GDP to below 30% by 2014–2015.

The lowered tax rates led to no loss in tax revenue for two reasons: part of that burden was shifted towards indirect taxes and lower rates

were accompanied by an increase of declared profits. This is true for all companies, Bulgarian and foreign alike, but especially for the latter – according to Jansky (2019) Bulgaria is the only country in the EU in which large international firms fully comply with the tax laws.

But after the reform there appeared a new unexpected challenge – the surplus spending that typically happens at the end of the year, and is often, arguably, done according to strict efficiency criteria, including 13th salaries in the state sector, subsidies in support of state-owned companies, unreasonable funding for municipalities, capital expenditure etc.

To address this issue, 2012 introduced fiscal rules stricter than those of the EU (a medium-term balanced budget target, 2% deficit allowance, a public spending and general government debt ceiling of 40% of GDP) and observed them strictly until 2020–2021.

The indirect taxes, which constitute a key source of budget revenue from high inflation periods of 1990's to the present day. (Compared to Scandinavian and OECD average reliance on indirect budget revenue, first of all VAT, Bulgaria's fiscal balance is twice more dependent on such revenues). Bulgaria applies the very minimum European rates for excise duties. The VAT has been unified (or flat) at 20% with no exception, in 1998 (only tourism services are taxed 9%) and, again until COVID-19 years, remained sector- and welfare neutral. In this situation, income taxes serve as an incentive to work and compete.

Low rates and simplified tax process have reduced the costs on tax compliance and created positive incentives for investment, fixed capital formation, raised productivity, economic growth and wealth in the country as it is registered in Credit Suisse annual wealth reports. On the negative side, however, the surplus spending, giving authorities room to maneuver, reduced the efforts to improve business environment and after 2012 (for populist political reasons) allowed for compromises with the rule of law. This combination eventually reduced the fixed capital formation and the levels of FDI about 10 times. The average 2013–2019 economic growth of 2.5% of GDP per annum was twice below the average of 5% of GDP for the ten year period before 2009.

After the successful lowering of income taxes to 10%, and the 2006 reform of social security contributions, the effective surpluses had stopped the reforms in the area of pensions and other saving sectors of the economy. The budget transfers to the pay-as-you-go pension fund had increased more than three times since 1998 but did not improve the efficiency of the pension system. Plus, the higher fiscal revenues were not used to improve the condition of some vulnerable groups such as pensioners, who lost savings in the years of hyperinflation; Roma or ethnic Turks.

On the whole, however, larger disposable income increases the wellbeing of the majority of citizens. According to EUROSTAT data on net annual earning, different categories of taxpayers show an increase in income after taxation for practically all social groups, except for those just mentioned. For example, for a middle-income taxpayer without children, increase in real income from 2011 to 2020 is 54%, but for one with a family of four and an income three times above the average, the increase for these ten years had been 44%.[17] Information from the National Revenue Agency of Bulgaria, is that the group of taxpayers with incomes at the level of the minimum wage had decreased, and that of taxpayers with conditionally determined average incomes had increased the fastest, but that this also happened in all other income categories.

At the same time it should be noted that in Bulgaria income taxes of 10% is combined with sizable social security contributions – 13.8% for employees and 19.2% for employers; the wedge on labor is 43% (OECD, 2022).

17) See: EUROSTAT: https://ec.europa.eu/eurostat/databrowser/view/earn_nt_net/default/table?lang=en

What exists is possible: in lieu of conclusion

Bulgaria's tax system factors, in features essential for tax compliance, such as simplicity, build-in compliance incentives, and motivation towards higher income achievements, and so on. A 2019 report on effective tax rate for multinational firms, commissioned by the Greens in the European Parliament, found that from all EU member states the statutory required taxes are only being paid in Bulgaria.

The tax system works well in recession, allowing for relatively flexible counter-cyclical policies, when revenues from corporate taxation decline.

Since tax simplification and base consolidation started in 1999–2000, and especially after the proportional tax reforms of 2007–2008, the budget registered sizable surpluses, increased transfers to the State Pension Fund almost three times, and doubled the amount of annual procurement on infrastructure. And the fiscal reserves helped weathering negative impacts of 2009–2010 recession, covering lost savings as a result of major bank bankruptcy (in 2014–2015, equal to 3% of GDP), and payment on a lost arbitration case (1.2% of GDP to ROSATOM in 2016).

Direct taxes, both personal and corporate, constitute a relatively small component of overall tax revenues but the levels are comparable to average OECD countries, as share of GDP. The system relies on low rates, no non-taxable income threshold, and is uniformly applied over a very broad tax base. The efficacy of the system is well documented by the annual budget performance reports (see: MinFin).

The country reforms with compromised "flatness", such as "zero" and unified rates on income above certain threshold, seem less stable. In almost all countries that have given up the proportional levies on income (irrespectively corporate and personal) the motivation to revoke the system had come from the management challenges of the pension systems but the counter-flat reforms did not improve those systems and resulted in restoration of tax-wedge levels of the time before the introduction of flat taxes.

In comparison to other countries, Bulgaria experience proves that any tax system could be made a good deal simpler. But it also allows for making two important conclusions.

First, with all its positive aspects and fortunate coincidence of the flat tax reforms with up-trends in the business cycle, favorable international economy or political developments (such as Bulgaria's accession to the EU), these reforms are no substitute for better functioning of the institutions.

Second, it is possible that in countries with better functioning institutions, flatter and simpler taxes could yield better results.

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Annex: List of countries with flat tax on labor income

The following table lists the countries that apply at least flat tax on labor income, understood as taxes on wage-income but excluding social security contributions (SSC).[18] Sub-national jurisdictions, e.g. Greenland of Denmark and UK offshore territories, are not listed.

Table 4. Rubrik

Country	Tax rate, %
Armenia	21.0
Belarus	13.0
Belize	25.0
Bolivia	13.0
Bosnia and Herzegovina*	10.0
Bulgaria**	10.0
East Timor	10.0
Estonia**	20.0
Georgia	20.0
Hungary**	15.0
Kazakhstan	10.0
Kyrgyzstan	10.0
Moldova*	12.0
Mongolia	10.0
Nauru	20.0
North Macedonia*	10.0
Romania**	10.0
Tajikistan	12.0
Turkmenistan	10.0
Ukraine*	19.5
Uzbekistan	12.0

Source: Wikipedia (accessed with a check on country currant situations on August 16, 2022).

* EU candidate status.

** EU member state.

18) The SSC are typically taken into account in calculations of the overall tax burden on labor, along with various consumption taxes.

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