Flat Tax — The British Case

By

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Preface

The British Case for Flat Tax

The British tax system currently operates through a system of allowances and bands of income. That is, each person is allowed to deduct a personal allowance from total income, which is then taxed at various "progressive" rates ranging from 10 percent to 40 percent. The allowance and tax rate depend on age and status, and the system as a whole has other characteristics that make it unnecessarily opaque, ineffective and administratively expensive. First, there is a separate National Insurance system, although there is little economic rationale for having separate systems. Second, dividends, capital gains, and interest earnings are taxed twice, once at the corporate level and then again at the shareholder or investor level, a situation that discourages investment and saving. Third, the multitude of allowances and tax bands increases the cost of running and auditing the tax system while increasing incentives for taxpayers to find loopholes that minimize their taxable income.

A fiscal system with only one tax rate for all levels of income, in which all income is taxed once and only once, might offer an advantageous alternative to the current system. The flat tax has already had remarkable results in countries around the world, such as Hong Kong, the Channel Islands, Estonia, Lithuania, Latvia, Russia, Serbia, Ukraine and Slovakia. Constantly endorsed by economists and politicians in the USA and UK, the flat tax would considerably simplify the tax system, thus saving taxpayers billions in direct and indirect compliance costs. It would give a boost to the economy by considerably improving incentives to work, save, invest and take entrepreneurial risks. The flat tax would also shift billions from investments that help people to avoid taxes, to those that produce goods and services.

The recent successful implementation of the flat tax in Eastern European countries has led a number of Western countries, including Germany and Spain, to discuss the flat tax alternative in their parliaments this year. Given the present trend towards fiscal simplification and the rise of the flat tax debate, this study seeks to:

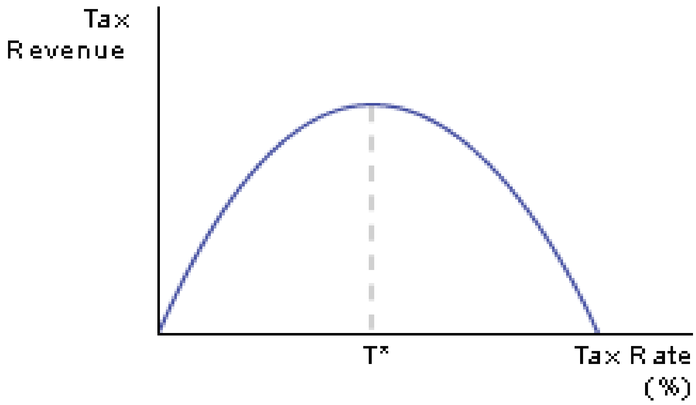
1. offer a brief, comprehensive overview of the flat tax;
2. examine the recent economic performances of countries that have switched to the flat tax system;
3. evaluate the prospects of introducing a flat tax in a developed country such as the UK.

1. An Introduction to the Flat Tax

The Laffer Curve: Tax Rate vs. Tax Revenue

Dr. Arthur B. Laffer is credited for offering the most convincing explanation of the relationship between the tax rate that the government imposes and the revenue that it collects. The "Laffer Curve" graphically portrays the trade-off between tax rates and tax revenues and it can be used to understand how a non-progressive flat tax need not decrease and might even increase overall tax revenue:

Figure 1: The Laffer Curve



The Laffer Curve suggests that tax revenue increases more steeply at low levels of taxation. As the tax rate further increases, the revenue increases at a decreasing rate, until the point at which the government collects the maximum amount of tax revenue point T* — after this point, any increase in the tax rate prompts people to work less, or to do more to avoid the tax, thereby reducing total revenue. At a hypothetical 100 percent tax rate, nobody would have any incentive to work at all, since the Government collects everything people earn.

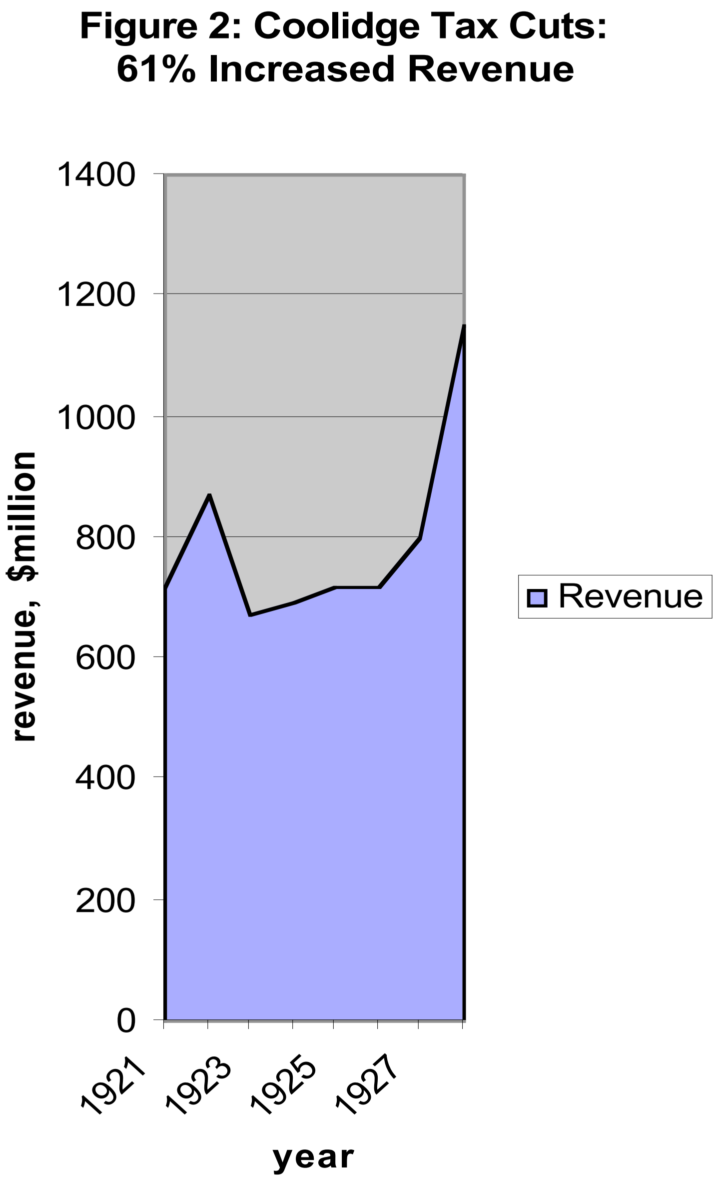
The Laffer analysis also explains how the government can obtain the same revenue in two different ways: by collecting a high tax from a small fraction of the population (a high tax on a narrow tax base), or by imposing a lower tax on a wider segment of the taxable populace (a low tax on a wide tax base). Consequently, an effective fiscal reform can also be accomplished in two different ways. On one hand, if the current tax rate is higher than the optimal rate T*, then reducing the tax rate would increase revenue by increasing the tax base. On the other hand, if the present tax rate is lower than the optimal rate T*, then increasing the tax rate would increase revenue, despite decreasing the tax base.

Proponents of the flat tax are convinced that the existing progressive tax system raises a barrier against working extra hours, reinvesting, or saving. They believe that taxes are higher than the optimal tax rate T* described by the Laffer analysis, and that a moderately low flat rate would increase tax revenue. They argue that if tax rates were lowered, people would have a greater incentive to work and invest, which would boost the whole economy.

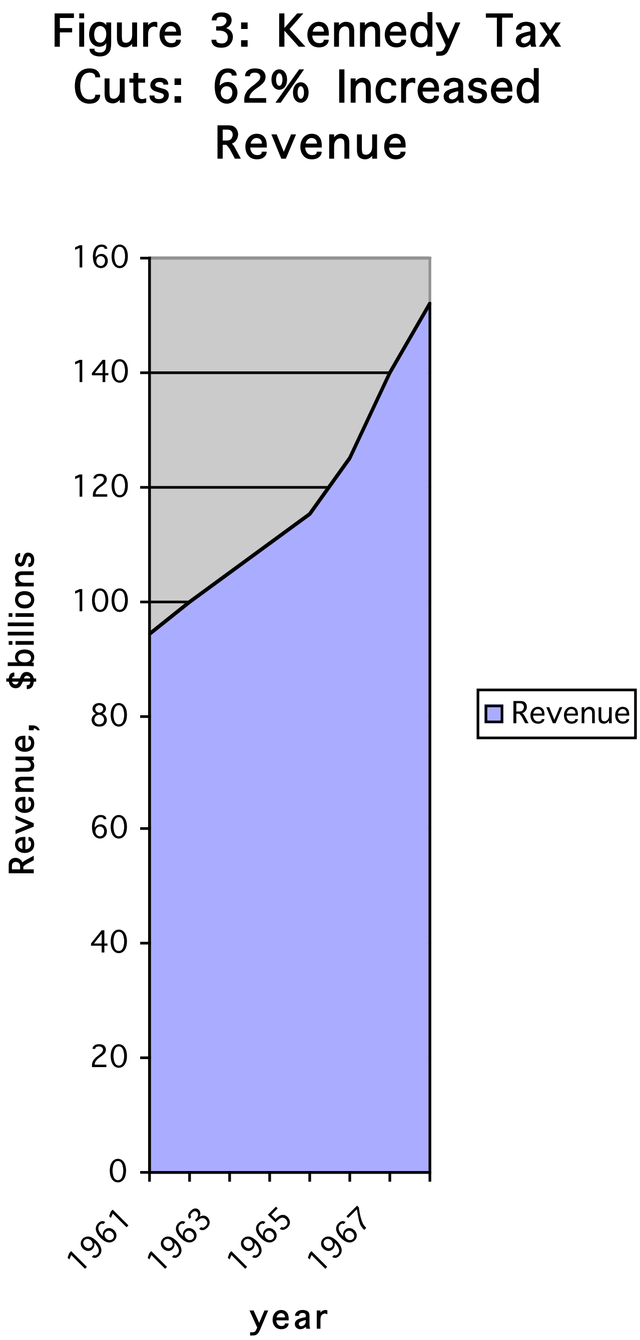
Tax Cuts in the USA

Although the economy can be significantly influenced by a variety of government actions such as monetary policy, regulatory policy, and trade policy, fiscal policy has always had a powerful impact on the state of the economy. Looking at three major tax cuts in American history, the Coolidge tax cuts of the 1920s, the Kennedy tax cuts of the 1960s and the Reagan tax cuts of the 1980s, one can discern a clear pattern: when tax rates are reduced, the economy prospers, tax revenues grow, and low-income citizens bear a lower share of the tax burden.

- *The 1920s:*President Coolidge reduced the top rate from 73 percent in 1921 to 25 percent by 1926. As a result, the economy grew 59 percent in real terms between 1921 and 1929, while annual economic growth averaged more than 6 percent. During the same period, personal income tax revenues also grew by more than 61 percent:

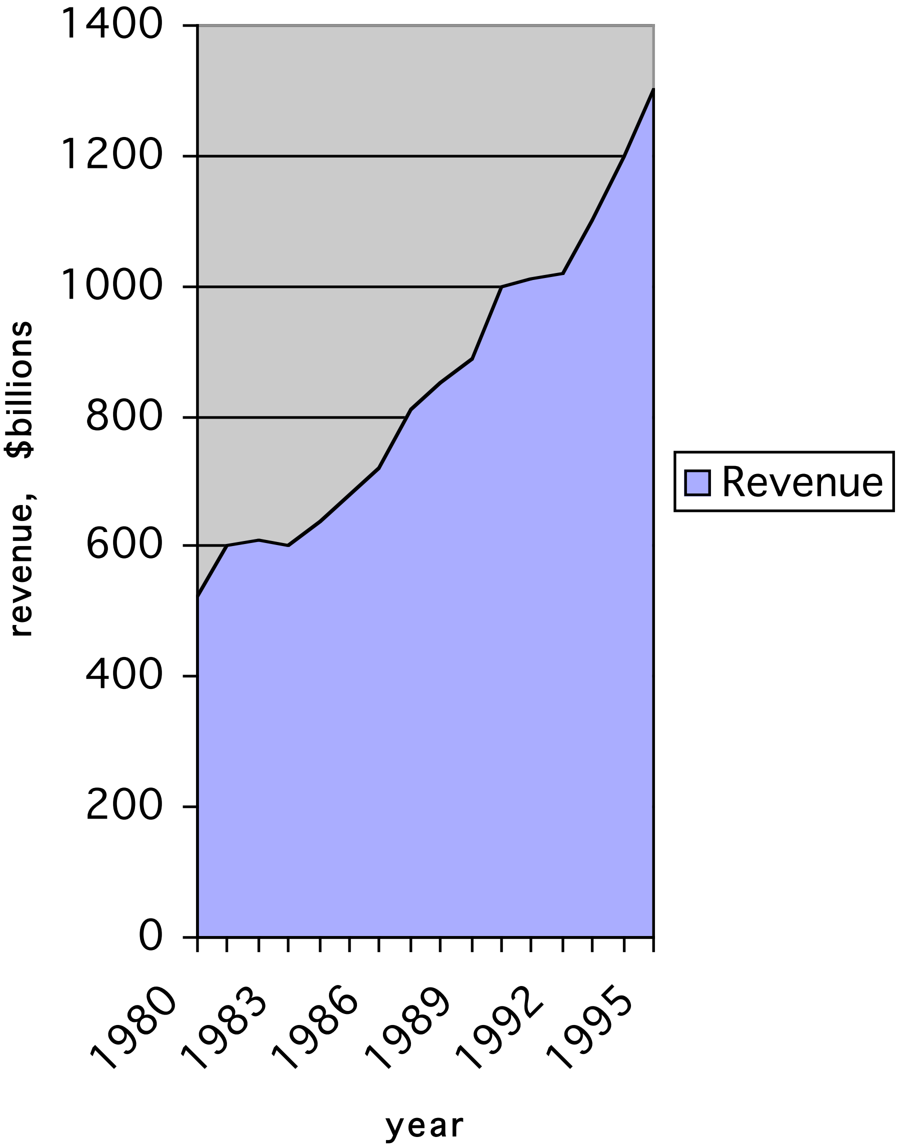


- *The 1960s:* President Kennedy reduced the top rate of taxation from 91 percent in 1963 to 70 percent in 1965. The following years brought the longest economic expansion in America's history: between 1961 and 1968, the inflation-adjusted economy expanded by more than 42 percent, a yearly average of more than 5 percent. During the same period, tax revenue also grew by a solid 62 percent:



• *The 1980s:* President Reagan reduced the top tax rate even more drastically, from 70 percent in 1980 to 28 percent by 1988. As a result, during the seven-year Reagan boom, economic growth averaged almost 4 percent per year. Total tax revenue also expanded impressively by 99.4 percent during the 1980s[1]:

Figure 4: Reagan Tax Cuts: 99.4% Increased Revenue



[1] Critics argue that the Reagan tax cuts caused the increased budget deficit of the 1980s. A very brief analysis shows that, as a share of GDP, federal revenues fell from 20.2 percent in 1981 to a low of 18 percent in 1984, and rose back up to 19.2 percent by 1989. Since from 1950 to 1995 federal receipts have averaged 18.4 percent of GDP, throughout most of the Reagan years, taxes as a share of national output were substantially above the post-war average. The large and sustained defence build-up and the unexpected rapid decline in inflation in the early 1980s are better explanations of the post-Reagan deficit.

In addition to generating greater revenues, tax cuts also encourage high-earning individuals to pay a higher percent of the tax revenue. In the 1920s, taxes paid by those making over $50,000 climbed from 44.2 percent of the total burden in 1921 to 78.4 percent in 1928. In the 1960s, tax collections from the rich climbed by 57 percent between 1963 and 1966. Finally, in the 1980s the share of income taxes paid by the top 10 percent of earners climbed from 48 percent in 1981 to 57.2 percent in 1988.

Why did lower tax rates increase the share of taxes paid by the rich? First, taxpayers in the highest brackets shifted money from consumption or tax-sheltered investments into more productive, taxable investments. Second, taxpayers became more honest as evasion became less rewarding. Third, some taxpayers, rewarded by higher after-tax returns, worked harder.

A Word about the Thatcher Tax Cuts

The history of tax cuts in the United Kingdom is mainly associated with Margaret Thatcher's period of office as Prime Minister of the United Kingdom between 1979 and 1990. Advocate of free markets and entrepreneurialism, Thatcher entered office with the main objective to reverse the socialism that she believed had done great harm to the British economy. Her economic program called for deregulation, privatization, tax cuts and a rigorous control of government spending in order to keep inflation low. On the international scene, "The Iron Lady" maintained a special relationship with American President Ronald Reagan, whose views regarding the economy and fiscal reform she often shared.

The first important tax cut in Great Britain took place in 1979, the year Prime Minister Thatcher first entered office. Chancellor of the Exchequer Sir Geoffrey Howe first cut the top rate from 83 percent in 1979 to 60 percent in 1980. Seven years later, Nigel Lawson, Chancellor of the Exchequer in the second Thatcher government, further reduced the top rate from 60 percent in 1985 to 40 percent in 1986. Thus, in only seven years, the British tax system went from a top rate of 83 percent to the top rate of 40 percent that we still have today.

The economic results of the Thatcher tax cuts are similar to those of the American tax cuts from at least two points of view. First, the tax cuts had a positive impact on government revenue: per-capita GDP at constant 1995 market prices rose from £9,276 in 1979 to £11,516 by 1990. Over the same period, Inland Revenue contribution to central government tax revenue rose from 55.9 percent in 1979 to 58.2 percent in 1990. Second, high–earning individuals ended up paying a higher percentage of the total revenue: the top 10 percent earners went from paying a 35 percent share of total revenues collected in 1979, to contributing 42 percent of total revenues in 1990.

Economic theory and historical evidence in both the USA and the UK shows that lowering taxes stimulates economic activity. A moderately low flat tax would therefore provide a stimulus to work, produce, invest, and save, thus promoting overall economic growth, job creation and government revenue. It would broaden the tax base by curtailing the incentive for an underground economy and thereby reducing tax evasion, avoidance and underreporting.

The Flat Tax, Rabushka–Hall Version

In 1985, Robert Hall and Alvin Rabushka from the Hoover Institution wrote *The Flat Tax*, a book that media magnate Steve Forbes described as "the flat-tax Bible". The tax reform developed by Hall and Rabushka is based on a single rate of taxation for all sources of income and represents a fundamental change in the way governments would collect tax revenue. The proposal achieves simplicity, economic efficiency, and fairness — the traditional measures of effective taxation — while also collecting the revenues required to finance the government.

An important characteristic of the flat tax system is that *it taxes all income once and once only*, as close as possible to its source. The current progressive tax system violates this principle in a number of ways. Some types of income, like fringe benefits, are never taxed at all. Other kinds, like dividends and capital gains, are taxed twice: once at the corporate level and then again at the shareholder level. Even worse, some types of income, such as interest income, can be either taxed or not taxed, depending on the taxpayer's ability to avoid taxation. By radically simplifying the tax system, by removing any deductions or reliefs, and by eliminating double taxation, the flat tax would rid the current system of these anomalies.

The other essential aspect of the flat tax system developed by Hall and Rabushka is that *it taxes income uniformly*, with no rate differentials between different types of income. All income is classified as either business income or wages, but taxes on both types of income are equal. The single exception that makes the Hall-Rabushka proposal to some extent progressive is the generous allowance exempting lower-income individuals and families from taxation. Consequently, under the flat tax system a significant number of lower-income families pay absolutely no income tax, while all families with income above the allowance only pay tax on the amount they earn above the exemption level.

The Individual Income Tax. Under the Hall–Rabushka proposal, only actual payments of wages, salaries, and pension benefits are deemed personal income and subject to personal income tax. Income from dividends, capital gains, interest, or fringe benefits are not subject to personal income tax because they are already taxed at the business level. Since the system also gets rid of all the credits, deductions, or additional exemptions, individuals and families would simply add up their income from wages, salaries and retirement benefits and subtract the personal exemption to arrive at their taxable income. This amount is then multiplied by the flat tax rate to determine the individual or family tax bill for the year.

Income Tax = Flat Tax x [Wages, Salaries, Pensions
less Personal Allowance]

The Business Income Tax. This second component of the Hall–Rabushka system is carefully designed to tax every bit of income other than wages, salaries, and pensions. The business tax has no deductions for interest payments, dividends, or any other type of payment to the owners of the business. Since all income that people receive from business activity has already been taxed, the tax system does not need to worry about what happens to interest, dividends, or capital gains after these types of income leave the firm.

Business taxable income is calculated by taking total revenue from the sale of all products and subtracting three kinds of payments. First, the firm would subtract wages, salaries, and pensions paid to workers, since income tax will be paid on these items. Second, the firm would subtract purchases of inputs from other firms, since the seller has already paid business tax on these items. Third, the firm would be able to deduct the entire cost of investment (plant and equipment) as an expense in the year of purchase. This immediate deductibility of investment both encourages capital formation and eliminates all depreciation schedules and the bureaucracy necessary to interpret them.

Business Tax = Flat Tax x [Total revenue from sales of goods
less purchases of inputs from other firms
less wages, pensions paid to workers
less purchases of plant and equipment]

One of the most destructive elements of the current tax system is that it punishes savings and investing with high tax rates and double taxation. But the Hall–Rabushka proposal exempts savings and investment from such punitive taxation. The flat tax is a *consumption-based tax*, because it provides an immediate 100 percent tax allowance for new investment and exempts the returns on savings (interest and dividends) from taxation. Thus, not only are efficiencies gained by moving towards a consumption-based system of taxation, but also considerable incentives are created for increased savings and the formation of capital.

2. The Flat Tax at Work

Historical Overview

The flat tax concept was the subject of heated debate in the mid 1980s. First, as we have seen, Robert Hall and Alvin Rabushka from the Hoover Institution published *The Flat Tax* (1985), one of the first and most exhaustive analyses in favour of the flat tax. The following year, Republican presidential candidate Steve Forbes based his campaign on the same simple idea: a single flat rate of income tax for all Americans. Soon, the echoes of the American debate reached the United Kingdom, where the idea of a flat tax was supported by a number of commentators.

Although the flat tax failed to materialize either in the USA or in the UK, a number of examples seem to show that the flat tax has been successful in boosting economies around the world. According to *The Economist* magazine, **Hong Kong's** adoption of the flat tax system through the Inland Revenue Ordinance of 1947 was essential for the expansion of one of the fastest–growing economies in the world: "The territory's tradition of simple and low taxes... is widely seen as a main reason for its stunning rise to prosperity" (*The Economist* 2000) The **Channel Islands** offer an even more convincing example of flat tax efficiency: a uniform rate of 20% has led their economy to clearly outpace the economy of England and Wales.

Furthermore, in the 1990s and the new millennium more countries have switched to the flat tax system, with impressive economic results. The three Baltic countries, **Estonia** (1994), **Lithuania** (1994) and **Latvia** (1995) were the first Eastern European countries to adopt a flat tax. Inspired by the success of fiscal reforms in the three former communist countries, **Russia** (2001) followed with a record-low 13 percent flat tax. **Serbia** (2003), **Ukraine** (2003) and **Slovakia** (2003) implemented the flat tax last year, which attests the continuity of the flat tax reforms.

Analysing the economy of countries in which the flat tax has already been implemented is a good start for assessing the potential of the flat tax to replace a progressive tax system. Of course, every country is a unique case, and the tax system is only one of the numerous factors influencing an economy. But looking at economic developments in a series of countries that have gone through the same kind of fiscal reforms will show the possible advantages of implementing the flat tax.

The Flat Tax at Work

Hong Kong (1947)

The Heritage Foundation, a Washington-based think tank, ranks Hong Kong *number 1, the freest economy in the world*, in its 2004 *Index of Economic Freedom*, a publication that uses ten economic indices to measure the degree of economic freedom in countries around the world. This year's ranking acknowledges once again Hong Kong's tradition of non-interventionist economic policy that has supported the fastest growing economy of the last half a century.

Since the Inland Revenue Ordinance of 1947, Hong Kong maintains a dual income tax system, which allows taxpayers to choose between a graduated and a flat system of taxation. The seven million inhabitants of Hong Kong can choose to be taxed progressively between 2 percent and 20 percent on income adjusted for deductions and allowances. Or they can choose a 16 percent flat tax on their gross income. This dual fiscal system allows taxpayers to choose the tax that minimizes their tax burden. However, taxpayers preponderantly choose the flat tax, which offers them lower tax rates, zero preparation costs and a vastly reduced probability of being audited and interrogated by the fiscal authorities.

Hong Kong does not have a general income tax, does not tax stock dividends, capital gains, wealth, or gifts, and has no value-added tax, general sales tax, or payroll tax. This combination of simplicity and low level of taxation has reduced the adverse effects of taxation on work effort, saving, and risk-taking and was a key factor in Hong Kong's remarkable economic growth and development. Notably, the flat tax has generated a high enough level of government revenue such that, between 1950 and 1981, fiscal surpluses have been recorded in no less than 27 years.

The Channel Islands: Guernsey (1960) and Jersey (1940)

Located in the English Channel off the northwest coast of France, the Channel Islands represent the last remnants of the medieval Dukedom of Normandy. Today, Guernsey and Jersey operate under a special constitutional status bestowed by the Crown, which allows them to implement their own political and economic policies. A combination of low taxation, stable government and lack of party politics has brought huge wealth to the Channel Islands by maintaining a highly attractive business environment.

Both Jersey (in 1940) and Guernsey (in 1960), have switched from the British income tax code to a flat tax of 20 percent, applied to both individual and corporate income. In addition to this relatively low rate, the new system provides generous allowances for both single and married individuals, as well as allowances for children and dependent relatives. According to the flat tax principles, the Channel Islands do not double tax dividends or interest payments, nor do they collect tax revenue on capital gains. Neither Guernsey nor Jersey collects a value-added tax.

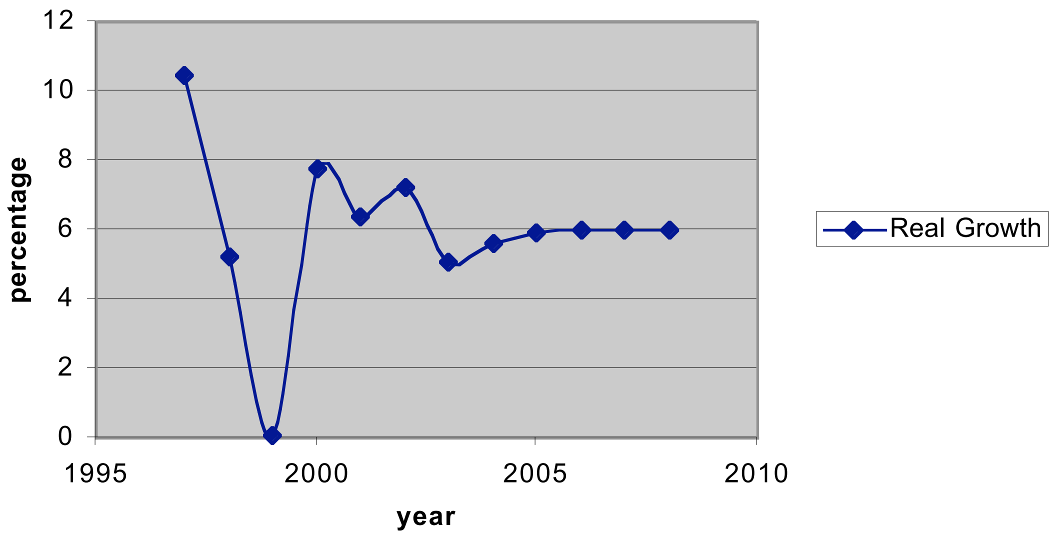
Since the introduction of the flat tax, the economies of the two islands have done remarkably well. Guernsey's GDP more than tripled since 1965, while Jersey's GDP rose 90 percent in real terms between 1980 and 1990. Economic performance in the Channel Islands proves once again that the efficiency, simplicity, and fairness induced by a flat tax have a positive influence upon economic growth, employment, and the overall standard of living. In addition, their Treasury has gained too: in 1990, income-tax receipts accounted for 74 percent of total government revenue in the case of Guernsey, and an impressive 90 percent in the case of Jersey.

Estonia (1994)

This small ex-Communist country is remarkably ranked 6th in the Heritage Foundation's 2004 *Index of Economic Freedom*. This incredible metamorphosis from a soviet-type economy to a free-market economy is the result of a series of principled reforms started by Prime Minister Mart Laar in the early 1990s. Since the dissolution of the Soviet Union and the regaining of independence in 1991, Estonia has implemented tight budgetary policies, foreign trade liberalization, and extensive privatization. In 1994, ignoring IMF advice to increase graduated tax rates, Estonia implemented a flat income tax of 26 percent, which turned out to energize what had been a stagnant economy. To further encourage capital formation, Estonia has also eliminated corporate taxes on reinvested profits.

The flat tax in Estonia encouraged capital formation, led to higher productivity levels, higher wages, and job creation. Because of its simple, low level of taxation, Estonia has also become a friendly environment for foreign investors: in 2003 direct foreign investments to Estonia accounted for 10.2 percent of GDP. Thus, thanks to a dynamic economy and rising foreign investments, Estonia presently enjoys a 5.6 percent GDP growth rate and the Estonian Ministry of Finance forecasts growth to stay around the 6 percent level over the next 4 years:

Figure 5: Estonia: GDP Real Growth



The importance of the flat tax to the Estonian economy is stressed by Estonia's recent resolution to further reduce its level of taxation. After other Eastern European countries have adopted a flat tax (e.g. Russia adopted a low 13 percent flat tax), Estonia decided to further reduce its level of taxation, so that it does not lose business to neighbouring countries. Accordingly, Estonia has ratified legislation to lower its flat rate from 26 percent today to 20 percent by 2007.

Lithuania (1994) and Latvia (1995)

The other two Baltic countries, soon followed Estonia with flat tax fiscal reforms. Latvia has a flat income tax of 25 percent and recently lowered its corporate tax from 19 percent in 2003 to 15 percent in 2004. Lithuania has a flat income tax rate of 33 percent, while the top corporate tax rate is 15 percent. Not surprisingly, the economies of the two countries have gone through a period of sustained expansion, real GDP growth over the last three years averaged 5.6 percent in both Latvia and Lithuania.

Estonia, Latvia, and Lithuania were the first Eastern European countries to show how sound economic reforms can miraculously transform ex–communist economies into free markets admired and sought after by investors around the world. The flat tax that has been implemented in all the three countries has helped create a competitive market environment, while at the same time avoiding destructive budget deficits.

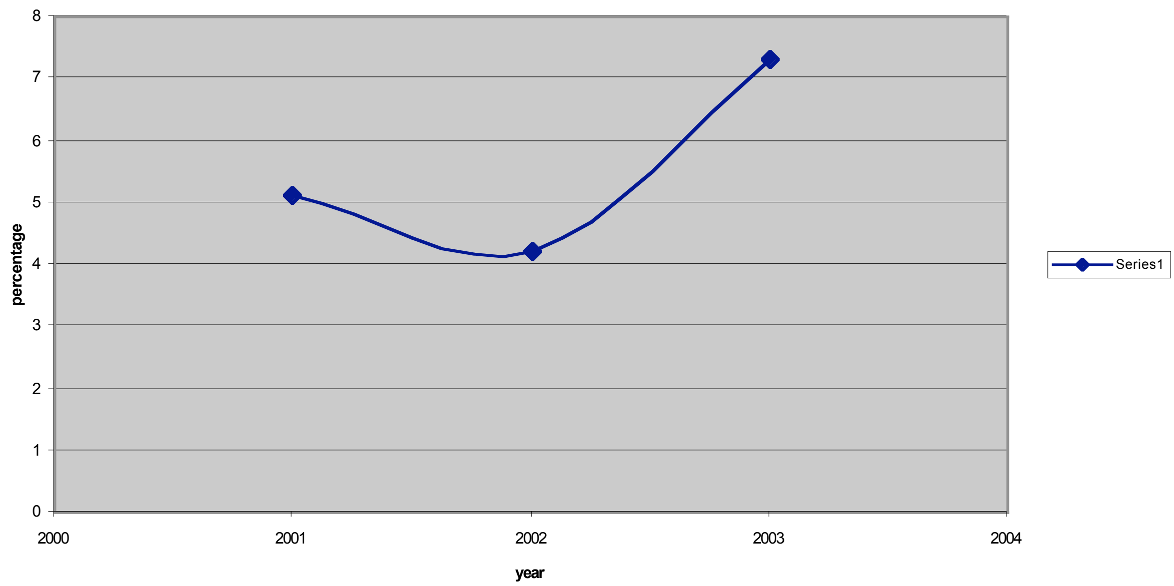
Russia (2001)

Free marketers around the world were somehow surprised when Russia switched to the flat tax system in 2001. Indeed, Russian President Vladimir Putin, the former head of the Soviet KGB, took a very radical step when he replaced the previous three-bracket system with a top rate of 30 percent with a low flat rate. The introduction of the 13 percent flat personal tax on January 1, 2001, followed by the 24 percent corporate tax on January 1, 2002, made the Russian tax system much simpler, more efficient and business-friendly than it was prior to 2001.

Four years after the implementation of the flat personal income tax, total real receipts from the personal income tax have more than doubled. After adjusting for inflation, personal income tax revenue increased 25.2 percent in 2001, 24.6 percent in 2002, 15.2 percent in 2003, and is predicted to total over 16 percent in 2004. This constant expansion of the government tax revenue is the result of less tax evasion and increased incentives to work, save, and invest.

GDP also grew at constant rates since the flat tax reform of 2001: 5.1 percent in 2001, 4.7 percent in 2002 and an impressive 7.3 in 2003. Thus the average annual real growth rate in Russia over the last three years averaged 5.5 percent, which is much better than the growth realized by many developed countries:

Figure 6: Russia: GDP Real Growth Rate



It might be still early to assess the overall impact of the flat tax on the Russian economy, and there are definitely a lot of things that Russia can do to create a nondiscriminatory environment for foreign investors, to protect intellectual property rights, and to reform the financial and banking sectors. But the adoption of a simple fiscal system based on the flat tax is an important step towards creating an operational free market economy. Even more encouraging for the global economy is the fact that countries from the ex-communist block are already implementing libertarian tax reforms before developed countries have managed to do so.

In ***2003*** more countries adopted the flat tax. First, ***Serbia*** voted in favour of a 14 percent flat tax rate on personal income and corporate profits, giving Serbia the lowest corporate profit tax rate in Europe. Then ***Ukraine*** followed Russia's footsteps by implementing a 13 percent flat tax on personal income, while also reducing the tax rate on corporate profits from 30 to 25 percent. ***Slovakia*** is the most recent country adopting a 19 percent flat tax on both individual and corporate income. Replacing an old system that included 90 exceptions, 19 sources of un-taxed income, 66 tax-exempt items, and 27 items with specific tax rates.

Less than a year since the implementation of the above fiscal reforms, it is too early to assess the economic performance of these countries. But given the history of economic expansion that followed the adoption of the flat tax in Russia or the Baltic countries, it will be interesting to examine the effects that the flat tax will have on the economies of Serbia, Ukraine and Slovakia.

3. The Flat Tax, a British Perspective

Tax Competition, A Benefit of Globalization

In a global economy in which workforce and capital move freely across national borders, fiscal policies adopted by every country have become very important in attracting the limited international resources. Emerging economies try to attract foreign investment by lowering their tax rates. Meanwhile, welfare states from Western Europe try to impose higher tax levels on all European countries, in order to protect their economies. However, countries all over the world have understood that in order to be competitive in the global economy, they have to make their economic environments as friendly as possible to international businesses.

Dr. Arthur Laffer, best known for his theory explaining how tax cuts lead to increased government revenues, has recently developed an interesting investment theory based on the difference in tax burdens among regions around the world. The Laffer investment strategy buys companies based in low-tax, low-regulation areas, and sells or avoids companies based in high-tax, high-regulation regions. Applied to Europe, Dr. Laffer's theory works remarkably well. The four lowest tax countries in Europe are Ireland, Latvia, Lithuania, and Malta. If you had invested £1000 in each of these countries on 1 January 2000, your £4000 would be worth £6750 on 15 August 2004. This 69 percent increase is a lot better than if you had invested in Europe's high-tax countries: Germany's DAX has lost more than 40 percent and France's CAC–40 is down by about 30 percent over the same period.

As a result of the increasingly competitive global market and of the flat tax success in countries from Eastern European, the fiscal reform movement has recently made its way to Western Europe. With widespread tax evasion and a black economy exceeding a fifth of its GDP, Spain is currently examining a flat tax reform proposal. In a paper entitled *"A Proposed reform of Tax System in Spain"*, Miguel Sebastian, the director of the Spanish Economic Office, recommends the adoption of a 30 percent flat tax on personal income in place of the current progressive system with a top rate of 45 percent.

Germany is one of the countries most severely affected by the succession of tax reforms in countries across Europe. Faced with high corporate taxes, German companies are currently considering moving their operations to countries from Eastern Europe, which offer more attractive investment environments. In order to stop this tendency, the German Council of Economic Advisers has proposed a 30 percent flat tax on both personal and corporate income. The flat tax would replace the current intricate fiscal system with a top income rate of 45 percent and an effective corporate rate of 38.3 percent.

Europe is the scene of most fiscal reforms, but the tax cut movement has gradually moved to other continents. Egypt has announced a 10 percent reduction of both personal and corporate tax rates. Barbados is debating a switch from the current tax system with a top rate of 33 percent to a 12.5 percent flat rate on both personal and corporate income. In Africa, Ghana has recently announced a reduction in its corporate tax rate. In 2003, *The Flat Tax* was translated into Chinese and the Chinese

Ministry of Finance is considering the reduction of the top personal income tax rate of 45 percent to no more than 20 percent. There is no doubt that flat tax reform is a subject of international debate.

The Flat Tax in the UK

In the mid 1990s, as a result of increased media coverage in the USA, the flat tax idea made its way to Westminster. Some British commentators, including a number of Conservative MPs, praised the simplicity, efficiency, and fairness of the flat tax system. Mr. David Shaw, MP for Dover, argued that a flat tax would mark, "the end of big government and complex systems of taxation" (*Financial Times*, 1996). Since the mid 1990s the flat tax has had continuous theoretical support from British politicians, commentators, and journalists.

For a practical analysis of the flat tax, consider a 20 percent flat rate that might replace the current three-bracket fiscal system with rates of 10, 22, and 40 percent. The flat rate would eliminate more than 30 forms of reliefs, exemptions and expenditures allowable under the present system However, the system would allow a £5000 personal allowance transferable between husband and wife, in case one of the spouses earns less than £5000.

It is hard to predict the overall macroeconomic effects of such a radical tax reform. Consider the change in government revenue as a result of introducing the flat tax. On one hand, a lower tax rate is expected to collect less revenue, since taxes equal only a smaller percent of each taxpayer's income. But on the other hand, a lower tax gives a boost to the economy and creates more sources of revenue for the government. Therefore, the overall effect of the flat tax on government revenue would depend on the magnitude of these two separate effects, which work in opposite directions.

According to economic studies of previous tax cuts in both the USA and the UK, a substantial tax cut would engender enough positive economic activity to avoid critical budget deficits. Moreover, according to historical evidence, the flat tax would increase the percent of government revenue paid by the highest-income individuals. Consequently, not long after its implementation, the flat tax would have important positive economic and social effects.

The most frequent objection to the flat tax asserts that such a reform would mainly favour the rich, by lowering their high marginal rates and by granting them improved incentives to expand their businesses. It is, therefore, worth assessing the impact that the flat tax reform has on individuals from different income classes. First, the flat tax would have no direct effect upon the 35 percent of adults who currently pay no taxes at all. Second, the £5000 personal allowance would exempt another estimated 15 percent of people from paying any tax, meaning that under the flat tax half of the taxable population pays no taxes at all. Third, the three quarters of taxpayers who currently pay the basic rate of 22 percent might pay more or less, depending on the extent to which they now take advantage of tax shelters for pension contributions and mortgage interest payments from the present system. Fourth, the 11 percent of taxpayers who pay the high rate of 40 percent would indeed pay a lower effective tax rate would soon contribute a larger share of the total government revenue.

Just as the flat tax modifies government revenue in a variety of ways, it also has a dynamic impact on individuals from different income classes. Taxpayers from all income levels would adjust to a greater or lesser extent to the changes in the tax system. Currently unemployed individuals might be able to find a job as a result of the economic expansion generated by the flat tax. Taxpayers who now pay the starting and basic rate might be willing to work harder since they would no longer face increasing marginal tax rates. Finally, top earners might switch their investments from activities than minimize their tax burden to those investments that actually bring them the highest profit. In general, all taxpayers would modify their behaviour, so that to best take advantage of the flat tax benefits. Indeed, a simple, low flat tax, which taxes consumption rather than investment or saving, is likely to cause increased economic activity for individuals at all levels of income.

Decalogue of the Flat Tax Benefits:

So far, I have presented the basic principles behind the flat tax proposal, I have showed the positive economic effects of the flat tax reforms in countries around the world, and I have described how a flat tax would work in the UK. The flat tax reform would have a huge impact on the whole economy, would modify the role of the government, and would influence Britain's position on the international business scene. Below is a synopsis of the ten most important benefits of a flat tax system:

1. **The flat tax eliminates double taxation on savings and investments.** Since all forms of income are taxed once and only once, people are free to choose whichever investment maximizes their profits. Without any government restrictions on certain types of investments, the economy is able to reach its full potential.

2. **The flat tax increases government revenue.** As a result of a more dynamic economy and less tax evasion, the government actually collects higher revenue. As shown by Laffer's analysis and by the history of tax cuts in both the USA and the UK, lower tax rates engender a substantial economic boom.

3. **The flat tax considerably reduces the time and cost of completing tax forms.** With tax forms down to the size of a postcard, the flat tax system makes tax filling much simpler and more efficient. Taxpayers save the money they currently pay for financial advice and guidance, while fiscal specialists are able to switch to more productive forms of economic activity.

4. **The flat tax ends special interest lobbying, which is responsible for the growing complexity of the tax regime.** Not only is the progressive fiscal system unnecessarily complex, but it also tends to become more and more complicated every year. By eliminating all reliefs and allowances, the flat tax gets rid of all tax lobbyists who try to get new loopholes in the system for the benefit of their businesses.

5. **The flat tax exempts the poor from paying any tax by providing a generous tax-free allowance.** Due to the generous personal allowance, a large proportion of low-earning individuals pay no tax at all. The personal allowance also makes the tax system progressive for people with average

incomes. Only rich people, for whom the allowance represent a minor part of income, pay a rate very close to the flat rate.

6. **The flat tax offers individuals more control over their money and reduces government infringements on privacy.** Instead of letting the government design biased policies and programmes, people are left with more money to take care of their needs. With diminished government involvement, each person takes individual decisions regarding their pension plans, their mortgage payment, and their charitable giving, none of which is tax-deductible.

7. **The flat tax reduces interest rates as a result of the tax-free status of interest**. Without an interest tax, lenders are satisfied with lower payments. Overall lower interest rates coupled with advantageous first year 100 percent write-offs favour entrepreneurial activity and increased capital formation.

8. **The flat tax reduces tax evasion, by lowering the opportunity cost of avoiding taxes**. People are more willing to pay the correct tax burden when the tax is lowered. Under a flat tax, individuals are less willing to cheat and risk being interrogated by fiscal authorities. Also, the government spends less money on monitoring and auditing a simpler fiscal system.

9. **The flat tax makes the British fiscal system more attractive to foreign investment.** In a global economy in which investors freely move across country borders, a simple fiscal system attracts global businesses. In turn, foreign investments further boost an economy with a simple, efficient fiscal system.

10. **The flat tax achieves simplicity, economic efficiency, and fairness.** These are the traditional measures of effective taxation. Evidence from countries that have gone through major fiscal reforms confirms which the flat tax is a viable alternative.

Let the British Choose the Flat Tax

The case for a flat tax has been around for over two decades. Robert Hall and Alvin Rabushka have published new editions of the *Flat Tax*, in which they answer all the criticism articulated against the flat tax. Economists and politicians across the world, from the USA to China, support the flat tax idea. Even more convincingly, the flat tax has actually worked remarkably well in all the countries in which it was implemented.

However, switching from a progressive fiscal system to the flat tax is a very radical reform and has to be carefully managed. So far, the flat tax has only been implemented in countries with an embryonic economy, such as Hong Kong in 1947, or with a transitional economy, such as Russia and the other countries from the former Communist block. Supported by proper economic measures, developing countries usually have the premises to enjoy high rates of economic growth. Undoubtedly, the flat tax has provided the healthy fiscal environment that has boosted the economy, by generating new business and attracting foreign investment.

Flat tax reformers in Britain might try to implement a dual fiscal system similar to that of Hong Kong. Under this system, British taxpayers would be able to choose between the graduated three-bracket system with all its reliefs and deductions, and a simple flat tax with a generous personal allowance, but with no deductions. Such a dual plan would preserve deductions for taxpayers, unless they freely choose to give them up. Thus it would circumvent the special interest group opposition, allowing the flat tax to be introduced to taxpayers.

One of the major shortcomings of the dual system is that it would not eliminate the double taxation of savings. On the other hand, it would offer taxpayers the precious option to choose the fiscal system that minimizes their tax burden, which might be enough to compensate for the double taxation of savings. Besides, lower tax rates, a generous personal allowance, an advantageous 100 percent first year write-off of investments, and reduced time and cost of filling tax forms, will convince people to choose the flat tax over the present graduated fiscal system. Let the British choose their tax system, and they will choose the flat tax.

Over many generations the British system of income tax, like that in many other countries, has grown ever more complex. It is now so far from the understanding of those who pay it, that experts and accountants have to be employed by anyone wishing to make sense of it, or to avoid unnecessary liability to it. It cannot be good in a democracy if citizens do not know what it is that they assent to.

Income tax is not only complex; it is perverse, diverting energy and resources into uneconomic behaviour forced upon people by the tax code itself. In terms of growth forgone and effort misplaced, its economic costs reach into billions of pounds each year, maybe tens of billions. The time is long overdue for a radical simplification based on a single clear rate from which low earners are exempt. A flat tax in Britain would rapidly raise more revenue from a low rate, lift thousands from the low–earner tax trap, and end the dubious 'double taxation' levied on many types of income. It would set free creative entrepreneurial energy to create the jobs and the wealth needed to secure our future prosperity.

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