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Flat tax in Central and Eastern European Countries. A form of the positive tax competition?

Even though, in its classical form tax system should first of all supply budget revenues (fiscal function), more than once it is burdened with other non-fiscal functions, e.g. with stimulation ones. Their nature is dependent on established of social-economy policy and influence the size of tax load. Increase of the public tasks range cause a growing demand for financial resources made by public sector. In almost all these cases it is satisfied through the making new or increasing of already existing tax burdens. It reaches to the situation in which taxes are become instruments of aggressive fiscal policy, in meaning of fiscalism with the whole its negative consequences. In effect losses for state budgets are noticed at revenues side as well as expenditures one. On the one hand, too fiscal tax system does not provide sufficient sources to finance public tasks, restrain the economic growth, on the other hand – and it is consequence of this first process – level of expenditures connected with the execution of public tasks increases due to payments of social benefits for the unemployed. From here is not far away to the budget deficit and public dept creation.

In order to restrain and reverse unfavourable trends, the governments of individual states once again reach for tax instruments, except that this time they have stimulating nature, not fiscal. Furthermore, this tax policy in range of flow of entities, goods, capitals, more than once, takes of the international dimension. As a result of it there is a peculiar competition between individual states, and if to its execution will be used tax instruments, we deal with **the tax competition**, meant as a transfer of corporations, payers, capitals to the countries with more favourable taxation. Undoubtedly, for doctrines and tax systems there are not unknown term of **unfair (negative) tax competition** to define pejorative meaning of it. However, it's worth thinking if possible functioning of process with the contrary character, namely **positive tax competition?** What kind of instruments have to be used, to really recognize this competition as a positive? Can the flat tax be this instrument, which is more widely applied in Central and Eastern European countries? There's no doubt that a positive economic environment is essential for these countries for the sake of continuous development of theirs as result of economic transformation. What are the reasons for more widely application of the flat tax? Is it enforced only by its level of taxation?

The main aim of the paper is to present the proportional systems of taxing in Central and Eastern European countries and to prove, that the flat tax in many respects, can be recognized as a form of the positive tax competition.

Flat tax in Central and Eastern European Countries

In present tax system of Western European countries in scope of income taxation, construction of the flat tax is not applied. The opposite trends are noticed in Central and Eastern Europe, where the proportional taxation came into force in legislations of many countries, justifying it the need of competitiveness rising in searching for new in investments, e.g.: Baltic States, Russia, Slovakia, Ukraine and also partially Poland from the beginning of 2004. There is possible to take a risk the statement that Europe has been divided into two areas:

- **Europe of progressive tax,**
- **Europe of flat tax.**

On large scale the idea of coming into force a proportional taxation appeared in the United States in the beginning of the 80's. Its propagators were two professors form Stanford University in California – Robert E. Hall and Alvin Rabushka[1], who prepared the reform project of American taxation system of personal and corporate incomes, based on uniform 19 % rate, with no tax relieves and allowances, but with the amount exempted of taxation in relation to people with low incomes. Moreover, there would have been subject to taxation income that would be allocate in consumption, not investments. Finally, this conception didn't get support of American Congress.

In Central and Eastern countries that decided to enforce the flat tax, it referred mainly to incomes. In general, turnover taxes, especially value added-tax (VAT) owing to its nature - has a proportional character in most countries. Although, there are occur so-called reduced rates and one basic rate. VAT will take into consideration the following analysis, because it determines one of main sources of budget revenues and also impacts on investment possibilities of entrepreneur and on running a business conditions.

Tax reform in former the Soviet Baltic Republics

- **Estonia**

Among former the Soviet Baltic Republics, the reform of proportional incomes taxation was enforced in Estonia the earliest. The reform was carried out under circumstances of the recession of Estonia economy what is shown by 8 % decrease of GDP in 1993.

From 1994 incomes are taxed of general flat rate 26 % and have been regulated by single Income Tax Act[2] including taxation of both private as well as legal entities. Its subject of regulation refers mainly to personal incomes. Generally, legal entities registered in Estonia and non-residents that have a permanent place of business in Estonia are exempted from payment of income tax on earned income. Income tax is imposed only on gifts and donations made, dividends paid by residents - legal entities and other transfers of profit, expenses and transactions that are not related to commercial activity (rate 26/74). The intention of legislator was encouraging taxpayers to investing made gains, not to consuming of theirs, which is agreeable with presented Hall's and Rabushka's

[1] R. E. Hall, The Flat Tax, Stanford University, Stanford, California 1995
[2] Income Tax Act passed 15th December 1999, Ministry of Finance of the Republic of Estonia - http://www.fin.ee/

conception. Till 1994 CIT rate was progressive character (15, 23 and 30 %), although from July of 1992 to the end of 1993 r. was already flat – 35 %.[3]

Taxable personal income (PIT) of 26 % rate includes, in particular, income from employment (salaries, wages, bonuses and other remuneration); business income; interest, royalties, rental income; capital gains; pensions and scholarships (except scholarships paid on the basis of law) and alimony payments received. There is also a basic exemption of EEK 12 000. Apart from general rate, there are withholding ones:

- on royalties, payments to non-residents for services provided in Estonia, and on payments to non-resident artistes and sportsmen - 15 %,
- on pension payments – 0, 10, 26 %.

Till 1994 PIT was progressive with three rates - 16, 24 and 33 %.

The legal basis of VAT is Value Added Tax Act[4] that came into force in 2002. The Act establishes three rates

- basic rate – 18 %,
- reduced rates: 5 % (for e.g.: books excluding textbooks and workbooks for basic school and gymnasiums; medicines and medical equipment; treatment of hazardous waste; theatrical performances and concerts; heat and solid fuels sold to natural persons) and 0 % (for exports; subscribed periodicals; textbooks and workbooks for basic schools and gymnasiums; electricity generated by wind and hydro-electricity, goods and services sold to non-profit associations and foundations).

- **Latvia**

The reform heading towards the proportional taxation of incomes was also realized in **Latvia.** The Law On Personal Income Tax passed 5th May 1993[5], has established general flat rate of 25 %. However The Law provides for various exemptions from taxable income: dividends received from a Latvian company out of taxed income, except dividends received from a non-resident, income from deposits in credit institutions, insurance indemnities, income from state and municipal bonds, income from property sales unless otherwise provided by law.

In range of corporate taxation till the end of 2001 was 25 % flat rate, which was reduced to 22 %, in 2003 to 19 %, and the present (from 1st January 2004) there is general rate of 15 %. Apart of it, Law on Corporate Income Tax[6] establishes 5 others flat-rates: 2% - payments from the alienation of immovable property in Latvia, 5% - the use or rent of property located in Latvia, the use of other forms of intellectual property, 10% - dividends, management and consultation services, 15% - copyrights, 25% - the sale of real estate in Latvia. Some groups of the legal entities (so-called “small enterprises”) have been granted a number of tax relieves with pro-investment character.

Regarding VAT in Latvia, there are 2 flat rates:

- basic rate – 18 %,

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[3] Jaan Taaler, Tax reform, in: Transforming the Estonian Economy - http://www.ibs.ee/ibs/economics/tee/taaler.html
[4] Value Added Tax Act passed 13th June 2001, Ministry of Finance of the Republic of Estonia - http://www.fin.ee
[5] Law on Personal Income Tax passed 5th May 1993, Ministry of Finance of the Republic of Latvia - http://www.fm.gov.lv
[6] Law on Corporate Income Tax passed 9th February 1995, Ministry of Finance of the Republic of Latvia - http://www.fm.gov.lv

- reduced rate – 0 % (export of goods and services, tourism services, some goods and services relating to technical assistance donations)

- **Lithuania**

Lithuania as a one of analyzed Baltic States decided to enforce flat income tax the latest. From 2002 there is in force The Law on Tax on Profit[7] referring to legal person taxation. The basic rate of CIT is 15 % and there are taxed dividends and other distributed profit at the same level. However, legal entities - non-residents are imposed of 10 % flat-rate. The Law includes some progressive elements, namely entities employ not more than 10 workers and income doesn't exceed 500 000 LTL during the tax year has been burden of 13 % lower rate.

The Law on Income Tax of Individuals[8] passed on July 2, 2002 has come into force from 2003. There are two rates: 15 i 33 %; first one is levied on income from distributed profit, interest, income from sporting, artistic activities, royalties, income from rent or sale or any other form of transfer of property, pensions and life insurance payments. Other ones are subject to 33 % rate.

The Law on Value Added Tax[9] has imposed 4 rates:

- basic – 18 %,
- others: 0 % (levied on export), 5 % (passenger transportation services , pharmaceuticals and medical products , hotel accommodation and other special accommodation services, organic food products), 9 % (services relating to construction, renovation, insulation and design of residential houses, engineering network building and territorial management).

Flat tax in Russia

The flat tax in Russian Federation has been imposed on personal income of 13 % rate[10]. It replaced with progressive form of individuals taxation with 3 rates – 12, 20 and 30%. Besides, there are some other ones which refer to the following specific income:

- 6 % - dividends,
- 35 % rate for: lottery winnings, insurance payments above the established limits, interest on loans, interest on bank deposits that exceeds the amount computed at 3/4 the refinancing rate of the Central Bank of Russia (for deposits in rubles) or at the 9% annual rate (for deposits in foreign currency);
- 30 % - income earn by non-residents.

Legal entities were taxed at the flat - rate of 35 % till 2001, which was reduced to 24 % year later. There are also allowances of pro-investment nature. They refer to "small business" that under some conditions, can choose to remit the lesser of a 15% flat tax on profits or a 6% flat tax on turnover. Eligible businesses would enjoy exemption from value-added tax, sales tax, property tax,

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7 Law on Tax on Profit, Ministry of Finance of the Republic of Lithuania– www.finmin.lt
8 Law on Income Tax of Individuals passed 2nd July 2002, Ministry of Finance of the Republic of Lithuania– www.finmin.lt
9 Law on Value Added Tax passed 5th March 2002 Ministry of Finance of the Republic of Lithuania– www.finmin.lt
10 The Rough Giude to Russian Taxation - http://www.deloitte.com/dtt/cda/doc/content/ru_tax%26legal_roughguide_290903.pdf

and social insurance taxes.[11] Moreover, two rates – 6 and 15 % are burden dividends paid out or received by companies.

The basic rate of VAT is 22 %, reduced – 10 % is imposed on foodstuff and children's goods and 0 % applies to the export.

The future of flat tax in Slovakia and Ukraine

The tax reform in Slovakia, initiated on January 1, 2004, has a comprehensive character. It contains not only income tax, but also VAT, excise (from 1st May 2004), road tax (from 1st January 2004), real estate tax (from 1st January 2004 or 2005). The reform is base on 4 pillars: neutrality, simplicity, effectiveness, fairness.

In range of PIT, progressive rates (10, 20, 28, 35, 38%) and 25% of CIT, were replaced with single one – 19 %. The same rate is in force at VAT. Furthermore, the reform eliminated most of relives and allowances in order to full clarity of whole tax system. The ambition of Slovak government is to reduce of budget deficit as much as its level would not exceed of 3 % of GDP, established on Maastricht Treaty.[12]

Table 1. Tax reform impact on the level of income and indirect tax revenues in Slovak budget of 2004 (in millions SKK)

	budget 2003	budget 2004		reform effects to budget		
	(A)	before reform (B)	after reform (C)	C - B	C : A	C : B
Income tax	73 399,00	89 500,00	63 400,00	-26 100,00	-13,62%	-29,16%
Indirect taxes	135 600,00	144 600,00	160 600,00	16 000,00	18,44%	11,07%
1. VAT	*99 400,00*	*107 900,00*	*118 400,00*	*10 500,00*	*19,11%*	*9,73%*
2. excise	*36 200,00*	*36 700,00*	*42 200,00*	*5 500,00*	*16,57%*	*14,99%*
Total:	208 999,00	234 100,00	224 000,00	-10 100,00	7,18%	-4,31%

Source: Ministry of Finance of the Slovak Republic – www.finance.gov.sk

Ukrainian government, preparing tax reform project modeled itself on flat tax in Russia[13]. The rates of progressive scale (10, 15, 20, 30 and 40%) were replaced with flat one of 13 % from beginning current year to 2006, from 2007 - it will be raised up to 15 %. Simultaneously, there are functioning 2 more rates: 5 % on interests and deposits, 26 % on gambling and winnings. The last one will increase to 30 % (double amount of standard flat rate) from 2007.

At the same time there was reformed taxation of corporate income. The new rate is calculated at level of 25 % (the previous one was 30 %). Withholding tax rates are levied on non-business income paid out to non-residents: dividends, royalties, interest – 15 %, international freight income – 6 %, interest income from certain state securities – 0%; and tax rates accrued on top of the payment: 0 and 15 % - insurance income, 20 % - income from advertising services.

VAT includes two rates: 20 % and 0 % (for export of goods and services).

[11] A. Rabushka, Completing Business Tax Reform - http://www.russiaeconomy.org/comments/070302.pdf and Tax Reform High on Russia's Policy Agenda - http://www.russianeconomy.org/comments/052202.pdf
[12] Ministry of Finance of the Slovak Republic – www.finance.gov.sk
[13] The Rough Guide to Ukrainian Taxation http://www.deloitte.com/dtt/cda/doc/content/TaxGuide_Ukraine_2003.pdf

Flat tax in Poland

In Poland in the range of CIT taxation, there is the general flat tax of 19 %, which has been come into force from the beginning of this year (in 2003 it was - 27 %). Polish legislator decided on such reduction in order to more activating enterprises, not only Polish ones and to high the scale of investments up at the same time. His action was also determined by the level of legal entities taxation in other countries, e.g. Slovakia, Ukraine. Corporate Income Tax[14] includes also other rates imposed on specify kinds of income:

- 10 % - shipping, air navigation,
- 19 % - dividends, other shares in profits,
- 20 % - income non-residents of: copyrights, management, accounting, advertising services,

For the first time, Polish Parliament has decided to enforce tax-flat rate on individuals' income but in very strict range. Namely, proportional tax refers to business income; individual entrepreneurs has a right to chose 19 % flat taxing or taxing on the general principles with basic progressive tax scale (19 %, 30 %, 40%). If they decide on the first form, then they could not exercise tax relives have granted taxpayers of the second form. It makes some inequalities in running a business between of these groups.

There are also rates imposed on income (with no deduction of expenses) that are not added to the other incomes (taxed on the general principles):

- 10 % - real estate selling, shipping and air navigation of individuals – non-residents, winnings, prizes,
- 19 % - interests on loans, deposits, securities, dividends and other shares in profits,
- 20 % - copyrights, management, accounting, advertising services of individuals – non-residents.

On March 11, 2004, Polish Parliament passed new Value Added Tax Act[15] that will come into force 1st May. Act includes 3 rates: basic – 22 %, reduced – 7 %, 3 %, and 0 %.

Table 2. The tax rates of PIT, CIT and VAT

		Estonia	Latvia	Lithuania	Poland	Russia	Slovakia	Ukraine
Personal Income Tax	basic rate	26%	25 %	15 %	19 %[2)]	13 %	19 %	13 %
	others	0; 10; 15; 26 %	15 %	33 %	10; 19; 20 %	6; 30; 35 %	-	5; 26 %
Corporate Income Tax	basic rate	26 %[1)]	15 %	15 %	19 %	24 %	19 %	25 %
	others	26/74	5; 10; 15; 25 %	10; 13; 15 %	10; 19; 20 %	6; 15 %	-	0; 6; 15; 20 %
Value Added Tax	basic rate	18 %	18 %	18 %	22 %[3)]	20 %	19 %	20 %
	others	0; 5 %	0 %	0; 5; 9 %	0 ; 3; 7 %	0; 10 %	0 %	0 %

[1)] Income is subject to taxation only if is appropriated to expenses and transaction not related to commercial activity.
[2)] The flat tax is imposed only on commercial activity of individuals. The others categories of income are taxed of progressive

[14] Corporate Income Tax Act passed 15th February 1992 - www.sejm.gov.pl
[15] Value Added Tax Act passed 11th March 2004 - www.sejm.gov.pl

rates in general.
3) VAT rates are applied new Act coming into force on 1 May. The Effective Act contains the same rates.
Source: drew up by author

The carried out analyzes of flat taxation in Central and Eastern European Countries have general and exemplary character. As it shown many of them aside from general flat rate, enforce on their tax legislation the other ones as well as tax relieves and allowances.

The flat tax model proposed by Hall and Rabushka (mentioned above) can be named as a classical, because they tired to come into force of it on a large scale. Comparing main guidelines of that model (single flat-rate, no tax relives and allowances, with the amount exempted of taxation in relation to people with low incomes and no taxing income allocated on investments) to analyzed models, they cannot be completely named as flat, with the exception of Slovak system. With reference to the last one, it can be affirmed as **a tax experiment** with pro-investment character, in positive meaning of this word.

Flat tax – a form of the positive competition?

A term of “tax competition”, quoted in the beginning of the paper, doesn’t explain when competition has unfair (negative) or positive character. Giving answer of the question – establishing some criteria, we have to recognize and classify “tax flat” to the appropriate group. Have these criteria been defined and commonly accepted by countries?

These issues have been subject to regulations of the Organisation for Economic Co-operation and Development (OECD) that established key factors determined whether a jurisdiction of the country can be recognized as a **“tax haven”** – that is applying **harmful tax competition.** These factors are[16]:

1. no or only nominal taxes on the relevant income – it is the starting point to classify a jurisdiction as a tax haven,
2. lack of effective exchange of information; tax heaven administration refuses exchanging of information referring to the transferred gains, what enables businesses and individuals to hide real value of their income against scrutiny by tax authorities,
3. lack of transparency in the legislation and administrative procedures, making possible of granting tax privileges to individual taxpayers with no clear criteria of theirs,
4. no substantial activities criteria, suggest that a jurisdiction may be attempting to attract investment and transactions that are purely tax driven.

Moreover, OECD publishes and updates information about countries with harmful tax practices. Some of them are recognized as a “cooperative tax haven”, the others - “uncooperative tax haven”. According to these data, flat tax systems of countries analyzed in the paper are not recognized as applying harmful tax competition. The main target of tax heaven is to gain capitals in order to avoid or to reduce taxation of them as well as to hide from taxation. Central and Eastern European countries enforcing flat tax conception also would like to gain capitals but the aim is completely different, namely – investment aim, through reducing of business costs. What’s more, incomes of these investment are taxing, unless the will invest once again. Thus, the flat tax can be defined as an instrument of positive

[16] http://www.oecd.org/document/23/0,2340,en_2649_33745_30575447_1_1_1_37427,00.html

tax competition also in other aspects, what were the basis of models proposed by Hall and Rabushka and the basis of Slovak reform:

- equality and general character, with low rates at the same time, but with no relieves and allowances denying of these principles,
- simplification, clarity and transparency of tax system,
- efficiency and effectiveness of tax system,
- reducing costs of functioning administration,
- reducing scale of a black economy,

These are the elements showing of its competitive essence in positive meaning.

On the other side, in investment aspect, tax system and flat tax shouldn't be overestimated. They are only elements of whole – economic and legal environments influence on running business.