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Lessons from eastern Europe's flat tax

A theory in the US is reality in Bulgaria and elsewhere in the region. Does it work?

By John Dyer — Special to GlobalPost
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SOFIA, Bulgaria — American economist Alvin Rabushka keeps the flags of about 30 nations — mostly post-communist countries like Bulgaria and Slovakia — in his office at Stanford University's Hoover Institution. They remind him of the bittersweet victories he's helped achieve since he co-authored "The Flat Tax" in 1985.

For while the United States has yet to scrap its progressive, graduated income tax in favor of a single rate, politicians in Sofia, Bratislava and other eastern European capitals have enthusiastically adopted flat taxes, often to the benefit of their treasuries and, some would argue, their economies.

"The whole thing has kind of taken on a life of its own," said Rabushka. "I don't push domestic politicians anymore. My approach is, keep pushing in the world."

Now Rabushka's push is coming full circle. Washington's deficit-driven interventions in the American economy since the 2008 Wall Street meltdown have led some to trumpet eastern Europe's experience with flat taxes as proof they would work in the U.S. The flat tax, advocates argue, could protect Americans from the massive tax increases the federal government might levy in the future to service the country's ballooning debt.

"It is rather ironic that former communist countries are moving in a free market direction while America becomes more like Germany or France," said Daniel Mitchell, a senior fellow at the Cato Institute in Washington, D.C.

But it's not certain that eastern Europe's success with the flat tax can be replicated in America. Critics said it's foolish to draw parallels between an advanced economy and those transitioning from centralized control with plenty of room to grow.

And while Americans would welcome a more straightforward tax return, voters have never shown an inclination to allow the affluent to pay the same proportion of their income as everyone else, said tax expert Chuck Marr of the Washington, D.C.-based Center on Budget and Policy Priorities.

"I think conservatives would overstate the relevance," Marr wrote in an email. "If the U.S. were to move to a flat tax and be revenue neutral, it would be a massive tax increase on middle class people — that is a central reason why it has never gained traction here."

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The flat tax hasn't been big news in the U.S. since Steve Forbes made it a central plank in his 1996 presidential campaign. Many tea party movement members are now calling for a flat tax, but it's not clear how many people they really represent.

In eastern Europe, however, where growth percentages have long outpaced those in western Europe and the U.S., right-leaning economists with advice from Americans like Rabushka have lobbied successfully for flat taxes. Since

Estonia implemented one in 1994, most of eastern Europe, including Russia but excluding major holdouts Hungary and Poland, have opted for a flat tax.

Starting in 2005, Bulgaria gradually shrank its income tax from three brackets with a top rate of 24 percent to a single rate of 10 percent, one of the lowest in Europe, said Georgi Angelov, an economist at the Open Society Institute in Sofia who helped draft the changes.

Bulgarian income tax revenues grew by 40 percent afterward, he said, partly from the then-booming economy but also because more earnings in the gray market were declared under the simplified system.

The spread of flat taxes in the region shows they are essential to remaining competitive, he added. “When you see it’s working for your neighbors, you decide to do the same,” Angelov said. “It’s like a disease, but positive.”

Angelov cautioned that U.S. policymakers were flirting with slowed growth if they continued to boost spending that eventually would require higher taxes. Formerly communist countries, he said, know how overweening governments can stifle productivity.

“The U.S. is going to see the same European problems with taxation: creating incentives for the gray economy, creating incentives for people not to work and to depend on the social security system,” said Angelov.

Robert McIntyre, director of Citizens for Tax Justice, a labor-backed group in Washington, D.C., disputed Angelov’s claims. Many ex-communist states, like Russia in 2001, upped enforcement among reforms that included a flat tax. “They probably didn't have a tax system before to speak of,” he said. “Anything would raise more money.”

When the U.S. income tax was created in 1913, it was very simple, McIntyre said. But, as the economy grew in size and complexity, so did the tax code. The same occurred about a decade after then-President Ronald Reagan simplified taxes in 1986. McIntyre predicted special interest groups in eastern Europe would win exceptions to their flat taxes, too, someday.

Many eastern European countries also continue to tax capital gains as income, a practice American flat tax advocates want to abolish. Average Americans show no sign of wanting Wall Street financiers to avoid paying taxes on their investment gains, said McIntyre.

Still, the flat taxers can hope. “If I can only get one western European country to do it, I think that would raise some eyebrows,” said Rabushka. “Maybe an independent Scotland would buy into it. Maybe we can break up Belgium once and for all and Flanders would buy into it.”

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