ICEG EUROPEAN CENTER

NEWS OF THE MONTH

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FLAT TAX IN CENTRAL AND EASTERN EUROPE

The new Polish government – elected in October – declared its intention on introduce flat tax, among others. Beside, the Czech, the Bulgarian, the Albanian parliaments accepted the change of acts on taxation in June, and the flat tax will be in force in these countries after 1st January 2008. Meanwhile, for more or less years, this instrument has been already used in the Baltic States, Slovakia, Romania, Serbia, Albania and, moreover, also in Russia, Ukraine and Georgia. The flat tax seems to be very popular in the Central and Eastern European Region. Only Hungary, Slovenia and Croatia remained resistant. This raises the question: Is the flat tax really effective instrument to support the economic growth, or is it just the result of a sharp, irrational craze of fiscal competition?

FLAT TAX IN THEORY AND PRACTICE

The original theoretical (Hall – Rabushka[1]) flat tax model differs very much from the practice. The sense of original flat tax model is that tax burden levied on every income is the same without any kind of tax allowance. In this case there is no importance of the source of income, as there is no need to distinguish the sources in tax base calculation. This would be a great simplification in tax administration and supplying of income data. On a limited scale, the flat taxation idea can be found almost everywhere, at least in less important types of tax, like tax on excises or interest rate etc.

In the practice, the adoption of single rate – that is called "flat tax" in public – usually includes some kind of tax allowance, i.e. on children, income level, employee's benefits in kind etc. On the one hand, the detailed administration of incomes and tax base is unavoidable. On the other hand, beside single rate, any kind of tax easing or tax free income – i.e. the tax free minimum wage – is actually a progressive tax system, where one of the rates is 0%. Any kind of adopted "flat tax" systems in the world are actually multi-rates systems.

However, the introduction of flat tax in practice is just a part of a comprehensive tax reform. It must be recognised that beside single rate, the countries cut the social benefits, the unemployment benefits, introduce direct private contribution to social services, reducing the number of tax types, what foreshadows the assumption, that not the single rate itself makes a country attractive for investors and economic activities.

IS IT WORTH TO ADOPT FLAT TAX IN CENTRAL AND EASTERN EUROPE?

When the Baltic States in the middle of '90s or Russia in 2001 introduced the single rate inward in each type of major taxes, they expected to have favourable impacts on tax revenues. One is the elimination of underground economy, thus more income were discovered or reported and the tax base could get broadened. The other is the Laffer-curve effect that means decreasing rates are less motivating for tax frauds but more for increasing economic activity, what would increase the reported income as tax base, too, so the actual tax revenue would grow. In the case of these countries, the radical tax cuts really resulted in sharp increase in tax revenues. However, it must be taken into consideration that those national tax authorities were not able to reveal more than half of the tax frauds. For example, the Russian authority could gather only the 8% of the obliged tax payments before 2001. Regarding the much better

[1] Hall, Robert - Alvin E., Rabushka: *The Flat Tax.* Stanford: Hoover Institution Press, 1995

present state of Central and Eastern European economies and tax authorities, policy makers should be careful with such kind of hopes.

Besides, there is a third motivation in Central and Eastern Europe why most of the countries prefers to introduce flat tax. They base their economic growth on capital inflow, and through introduction of flat tax they try to re-weight the national tax revenues to favour the direct investors in the tax burden on corporate income and labour cost cutting the corporate sector to the quick.

Table 1. Flat Tax Systems in Central and Easter Europe

Countries	Year of introduction	Tax rates after reform (%)		Tax rates before reform (%)	
		PIT	CIT	PIT	CIT
Estonia*	*1994*	26	26	16-33	35
Lithuania*	*1994*	33	29	18-33	29
Latvia*	*1997*	25	25	10-25	25
Russia	*2001*	13	37	12-30	35
Serbia	*2003*	14	14**	10-20	-
Ukraine	*2004*	13	25	10-40	30
Slovakia	*2004*	19	19	10-38	25
Georgia	*2005*	12	20	12-20	20
Romania	*2005*	16	16	18-40	25
Montenegro	*2007*	15	9	16-24	15-20
Macedonia	*2007*	12***	12***	15-24	15
Czech Republic	*2008*	15	19	12-32	24
Bulgaria	*2008*	10	15	10-24	15
Albania	*2008*	10	10	-	20
Poland	*2009*	15	15	19-40	19

** see Figure 1. for current PIT rates, **today it is 10%, *** 10% since 2008,*
Sources: portfolio.hu, www.worldwide-tax.com, Hoover Institution, www.settimes.com

The fans of flat tax argue for foreign investment and the promise to free up economies for growth, by increasing economic activity and dropping tax evasion. In the region of Central and Eastern Europe, countries are challenged by corruption, inconsistent implementation of laws, high volumes of unregistered trade and not always adequate protection of property rights. Flat taxes are expected to help counteract such problems by closing loopholes and unmasking evasion techniques.

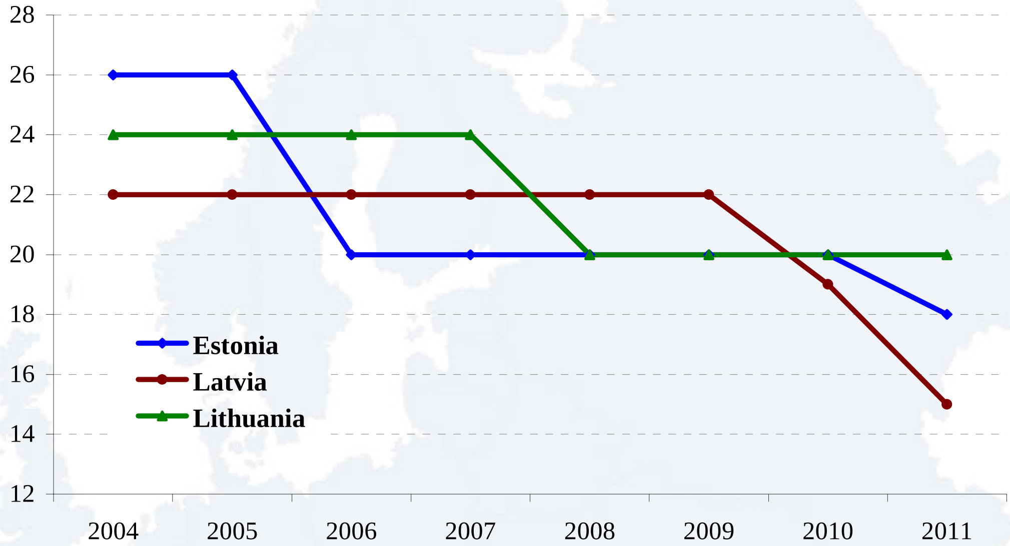
On the surface, the introduction of single rates caused increasing capital inflow share in the adopting countries, but actually, the improvement in national capital attraction occurred because of lowering direct tax rates comparing to sales tax, besides, the tax reforms generated simpler tax return administration at companies.

According to the World Bank and IMF reports on flat tax systems in 2006, the amount of tax revenues decreased in most of the countries adopting flat tax. This can cause serious fundamental crisis or political tension, as it comes to adjust the public expenditures to decreasing tax revenues by curtailing social benefits and institutional or industrial subsidies. The revenue shortage is not true in Slovakia and Romania, where the fiscal authorities reported increasing volume of tax revenues. These countries were aware in the adoption of single rate. They chose a higher rate among alternatives on purpose just to avoid shortage of revenues.

The international cross-country reports also disapprove that the tax systems have not got transparent after adoption of flat tax. Actually, it is because the practical adoption is just a quasi flat tax system with hidden rates caused by allowances.

An argument against progressive taxation with many allowances is the case, if the tax system is very complex, since on one hand, the business administration cost of tax payment is high, on the other hand, the high income owners can apply consultants, how will help to evade a part of taxes.

Chart 1. Baltic Tax Reduction on Incomes



Source: IBRD: World Bank EU8+2 Regular Economic Report, January 2007

But the fiscal policy must calculate with such aspects of flat tax system what can be considered unfavourable from certain views. As the flat income tax system means decreased upper rate and increased lower rate, the substitution of progressive tax with flat tax will burden individually tax increase for the majority of tax payers, since the weight of the previous lower rate is higher for the middle and the lower classes, in first step. The simplicity of flat tax system means, also, there are no exemptions, nor privileges.

In case of same single rate for PIT and CIT, the sense of the reform is to exclude the possibility of individual choice between salary payments or invoicing, so, no room left for tricking. But the case of converging toward completely same rate for any types of taxes would eliminate the ability of economic policy to prefer any kind of priority in investment incentive or social policy.

The single tax rate can be useful as a part of radical tax reform, when the purpose is to cancel any exemptions, privileges, preferences or allowance. According to the introduction of flat tax, it is easier to diminish all the allowance together then just to fight with each group of interest separately. Actually, not the single tax rate seems to be attractive for the companies, but the simplicity of administration and the low level of tax burden.

INFLATION RATE STILL ACCELERATES IN UKRAINE

Ukraine closed the year of 2006 with a CPI inflation that amounted to 11.6% year-on-year. As a result of the temporary fall of food prices, consumer prices inflation decelerated to 9.5% year-on-year in February, however, inflation rate decrease was counterweighted and it returned to double digits soon. Besides the slow, continuous growth of food prices in March, expansive fiscal policy and wage developments put further inflation pressure on the economy. Ukraine faced a consumption boom that started already in 2006 due to the strong increase in household income, pushing the inflation rate over a level of 14.8% year-on-year in October and still accelerating.

PRICE DEVELOPMENTS

Although government officials have made several statements regarding possible ways of bringing the inflation rate down, unexpected increase of food and imported gas prices characterised the Ukrainian economy from the first quarter of the year. Changes in inflation rate could have been achieved by the governments' price regulation policy. Contradicting the expectations, the government expanded the list of products subject to import licensing in 2007 with such products as poultry, meet products, sugar, sugar syrup and prepared food products containing cacao. The official excuse concerning new regulations was the enhancement of food quality control, however, since other types of quality control instruments – like sanitary and veterinary controls - could have been applied, the policy behind licensing seemed to be rather an additional protectionist shield for domestic procedures.

The ongoing political crisis and election campaigns were expected to impact the inflation rate development significantly, but the fact that CPI inflation peaked at 13.0% year-on-year in June can be explained by other factors; growth of world prices and poor harvest conditions that led to an increase in grain prices contributed mainly to the CPI increase in 2007. Lasting drought this spring in Ukraine caused such damages in agriculture that the low grain harvest had to be counter-balanced with export quotas for wheat, barley, corn and rye from July. The export quota introduced by the government to ensure food security for bread was limited to 3000 tons, basically banning grain export from the country. With such export restrictions the price stability could be maintained, however costs of this policy were so high that it was unfavourable for the economy in general, hurting investment climate and damaging the agricultural potential of Ukraine. While state regulations constrained grain prices, a jump in potato prices could be observed with the help of improved methodology in statistics.

Table 2. Economic Trends in Ukraine, 2007

Indicator	*Note*	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
GDP growth (real)	*% yoy*	9.3	7.9	7.0	7.6	7.7	7.8	7.2	5.8
CPI	*% yoy*	10.9	9.5	10.1	10.5	10.6	13.0	13.5	14.2
Industrial production (real)	*% yoy cum.**	15.8	13.4	12.5	12.5	12.1	11.8	11.2	10.9
Agricultural production (real)	*% yoy cum.*	6.9	5.6	5.0	3.4	2.4	6.3	5.5	-3.4
Merchandise exports (USD)	*% yoy cum.*	37.2	34.5	33.0	35.3	34.4	32.9	31.9	…
Merchandise imports (USD)	*% yoy cum.*	36.5	35.7	32.2	35.9	35.0	33.8	35.0	…

*cum. = cumulative

Sources: State Statistics Committee of Ukraine, NBU, IFS, Ministry of Finance

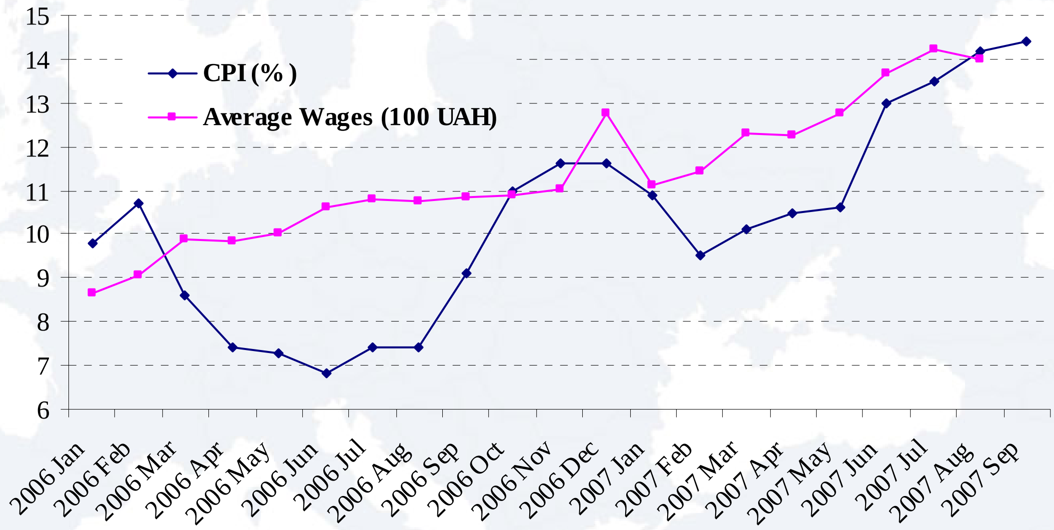
Inflation in August and September accelerated further – up to 14.2% and 14.4% year-on-year, respectively – as livestock products continued to grow due to both increasing feedstock costs and high consumer demand. During the summer, the prohibitive quota on grain export, originally lasting until October was prolonged until November 1. Once, joining the World Trade Organisation, it will put an end to trade restrictions and protectionist governmental policy that put such strong pressure on domestic price developments this year.

CONSUMPTION AND WAGES

As mentioned above, increase in internal and external demand has also contributed to the acceleration of the inflation that peaked at 14.8% year-on-year in October. The reason for the high demand and consumption growth from 2006 is the constant increase of real household income.

In the first half of 2007 the central fiscal revenues were 4.6% above the plan, mostly from enterprise profit taxes and strong growth profits in the economy. In May, the parliament approved amendments to the State Budget Law for 2007. As a consequence, central fiscal revenues further increased. The expansive fiscal policy could be financed with these additional funds. The funds gained by the government were mainly spent on wage and pension increases and other social payments.

Chart 2. Consumer Price Index and Development of Average Wages



Source: State Statistics Committee of Ukraine

According to the State Statistics Committee of Ukraine, in the first quarter of 2007 real households consumption increased by 14.7% due to the growing wages and pensions, increase in social transfers and more easily accessible household credits. The social policy of the Ukrainian government led to 17.5% growth of household incomes in the first four months and slightly decreased afterwards, since a less expansionary policy was introduced later this year. Average monthly wage was UAH 1113[2] in January and reached UAH 1421[3] in July. The highest rate of growth in wages was experienced in the education, health care, public

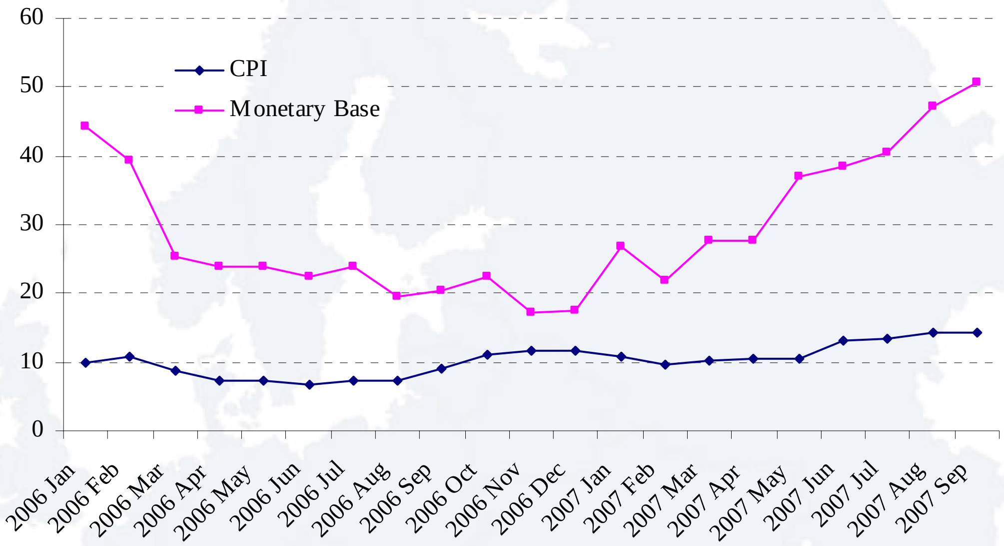
[2] UAH 1113 = EUR 150 (USD 222)
[3] UAH 1421 = EUR 191 (USD 283)

administration and agriculture sectors. Minimum wage, pension and subsistence minimum were also gradually increased, even above the levels planned in 2006.

MONETARY POLICY

The reduction of inflation has become the primary focus of the Ukrainian monetary policy. Not just expansive fiscal but monetary policy was introduced in 2007, to react on the economic effects of the consumption boom. While the monetary base grew by 21.1% in February, it accelerated to 36.9% year-on-year already in May. The National Bank of Ukraine (NBU) decreased the discount rate from 8.5% to 8% effective June 1, and adopted new consumer credit disclosure rules that were expected to contribute to the decline of interest rates in the economy.

Chart 3. Consumer Price Index and Monetary Base Development (%, y-o-y)



Source: State Statistics Committee of Ukraine

Monetary base expanded by 50.6% year-on-year in September as the NBU continued buying foreign exchange on inter-bank market and increased its international reserves by USD 1.8 billion.

The International Monetary Fund (IMF) has for years urged the Ukrainian government to liberalise its regulation of the national currency, since the Hryvnia (UAH) is significantly undervalued. In addition, the huge amount of inflow of foreign capital continues to put more and more pressure on the exchange rate. However, currency appreciation was not yet introduced by the National Bank, though it could be one of the moves that would moderate the high inflationary pressures. Revaluation as well as the regulation of prices is likely to happen after elections, albeit political uncertainty during the election campaigns did not affect the economy considerably. Current government's monetary expansion and generous social spending – strong private income rise and sharp expansion of households' credits - has added too much demand side pressure on prices. Greater exchange-rate flexibility could serve as the first step towards an inflation-targeting regime.

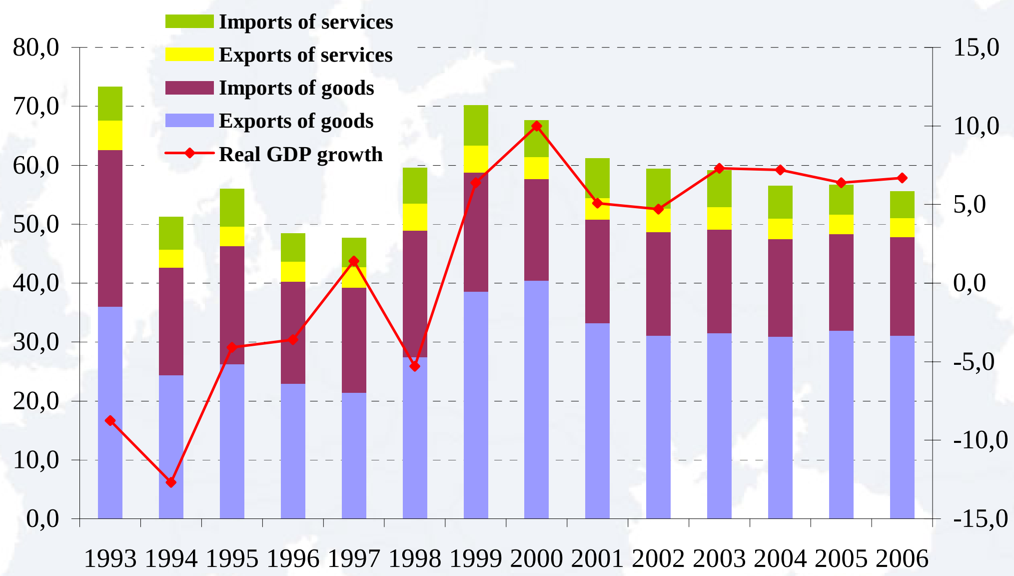
Decreasing Openness and Increasing External Biases of Trade in Russia

In 2006, the openness of Russian economy, measured by the ratio of total exports and imports to GDP, decreased to 55.6%. In the same time, the share of mineral products in total exports of goods increased considerably up to 64.5%, reflecting biased economic structure and rather re-diversification.

Closing Economy?

Openness of the economy used to be measured by the total exports and imports of goods and services as a ratio of GDP. By this indicator, Russia experienced fluctuating period in 1993-1998. After the economic crisis in 1998, mainly due to sharp revaluation of the national currency, the price competitiveness of the economy increased that caused, especially in the case of exports of goods remarkable growth. In 1999, total trade of goods and services reached 70% of GDP. However, in 2006 this indicator felt to 55% of GDP. (*Chart 4*)

Chart 4. Openness of Russian Economy, 1993-2006 (% of GDP)



Source: WIIW

What is also interesting, the share of exports of goods in the total trade turnover increased in 2002-2006 up to 58%, especially driven by the export of mineral products, as it is elaborated in the *Table 3*. It is even more problematic, if taking into consideration that the share of high value added products in the export is low, most of them are products of low processing, like metals, wood products, and of course all kind of fossil fuels and their by-products.

Table 3. Export of Goods by Main Commodity Groups, 1995-2005

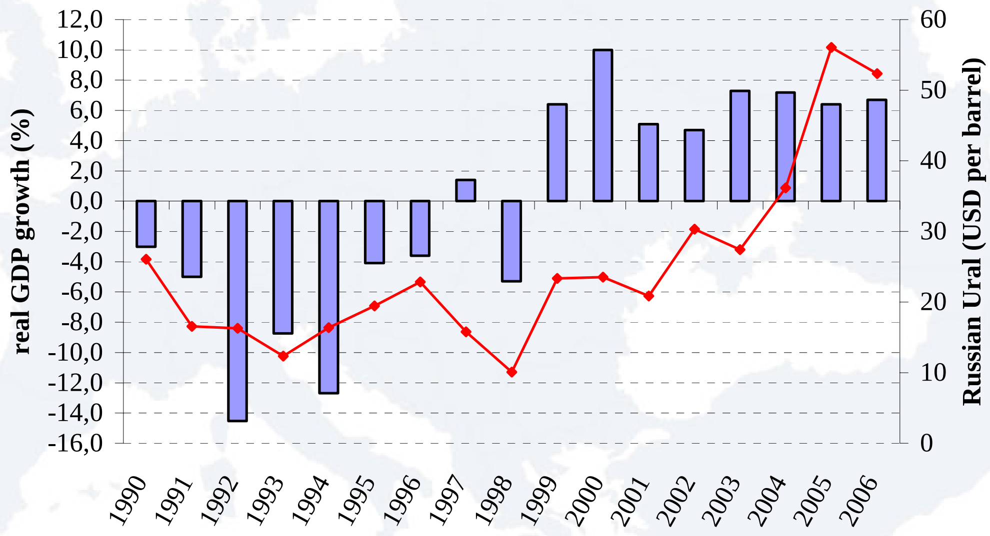
	1995	2000	2001	2002	2003	2004	2005
Total export (million USD = 100%)	**78217**	**103093**	**99969**	**106712**	**133656**	**181600**	**241219**
Food products and agricultural raw materials	1,8	1,6	1,9	2,6	2,5	1,8	1,9
Mineral products	***42,5***	***53,8***	***54,7***	***55,2***	***57,3***	***57,8***	***64,6***
Chemical products	10	7,2	7,5	6,9	6,9	6,6	6
Leather raw materials, fur and articles there of	0,4	0,3	0,2	0,3	0,2	0,2	0,1
Wood and pulp-paper products	5,6	4,3	4,4	4,6	4,2	3,9	3,4
Textile, textile articles and footwear	1,5	0,8	0,8	0,8	0,7	0,6	0,4
Metals, precious stones and articles there of	26,7	21,7	18,8	18,7	17,8	20,2	16,9
Machines, equipment and transport means	10,2	8,8	10,5	9,5	9	7,8	5,6
Other goods	1,3	1,5	1,2	1,4	1,4	1,1	1,1

Source: Federal State Statistics Service

Reasons and Outcomes

It is clear that the leading factor behind current developments of decreasing openness and biasing economic structure is the commodity price (not only fossil fuels) developments observable in the world. The prices of oil have increased sharply since 2001, while the demand for fossil fuels of Russia has not decreased. Naturally, the world growth driven market demand and supply factors caused the hike in crude oil and natural gas prices.

Chart 5. Real GDP Growth and Crude Oil price, 1990-2006



Note: Russian Urals Spot Price FOB (USD per barrel), Gross domestic product, constant prices annual percent change. Source: WIIW, EIA

The increasing oil prices improved extremely merchandise trade balances, while through strengthening real effective exchange rates the price competitiveness of non-fossil fuel related branches, and especially of the non-oil manufacturing sectors deteriorated considerably.

The excessive reliance of economic performance on natural resources blocks the natural transition process of the overall economy, i.e. shifting to more competitive economic structure, based on higher value added production. We have to also mention, that the natural resource abundance undermines economic processes also through weak institutions, giving floor for rent-seeking, state intervention, low competition, corruption and poor political democracy.

IMPLICATIONS

Russia has to achieve the WTO membership that is the only opportunity for Russia to increase its non-commodity trade, while also proving necessary imports.

It is also in the interest of Russia to improve its relations with the European Union, as the main export destination of the country. Around 80% of total exports go to the EU, while it is clear that considerable part of it consist of fossil fuels. By arranging bilaterally favourable deal on trade, capital and energy issues can lead to more opened EU markets. The attraction of FDI into the main manufacturing and services branches also a great opportunity to increase trade turnover and to improve its structure towards more sophisticated products.

14% of total exports realised in CIS countries. The more balanced and less politically determined, mutual and not biased relations might lead to better trade cooperation. For Russia, with traditionally relatively better industrial background, these markets still can be attractive, especially if these economies also faces increasing purchasing powers, also partly based on accelerated commodity exports. Reshaping the in essence non-operating integrations, like CIS, or rethinking the establishment of real free trade zone can be a solution as well.