EUROPEAN TAXATION – BETWEEN FLAT AND PROGRESSIVE TAX

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Abstract. *The paper presents the tax rates applied in the European Union, with a comparison between the progressive and the flat tax. In the first part, we discuss about general characteristic regarding the tax system in Europe, fiscal policies applied and about particularities of the two tax rates: progressive and proportional. We started specifying the reasons that brought to the forefront the flat tax in the European tax system and then we countinued by highlighting the advantages and disadvantages of progressive taxation on the one hand and of proportional taxation on the other hand. Making this comparison and analyzing different relevant opinions, we think that the choice of the right tax system can not be the same for each Member State because there is no general valid answer. Moreover, this choice has a fairly large political implication and this idea may be a possible interpretation of the fact that the flat tax has been embraced in Europe by the post communist countries. Further, we analyzed the effects on the budget revenues brought by the flat tax in the fiscal enivronment and we correlated them with the tax structure of each mentioned country. Theoretically, if we consider that the flat tax brought benefits in the tax system, Member States should record growth in the budget revenues, due to the reduceed tax evasion and increased foreign investments.So, we compared the volume of the budget revenues in two different periods of time: before and after introducing the flat tax. We observed that the flat tax didn't had the expected effects because the budget revenues had not suffered a positive evolution by changing the way tax percentage is applied We also brought the discussion current European fiscal approaches regarding the tax rates and we found that starting with 2013, some post communist countries had returned to progressive tax system. In the end, we emphasized the conclusions obtained with this paper.*

Keywords*: flat tax; progressive tax; fiscal policy; budget revenues.*

Introduction

The tax system is one of the main elements of international economic relations established between states. More broadly and looked through a simplistic approach, the tax system is expressed by all taxes of a state. But beyond the main aim on public expenses generated by the public needs, the tax system should be regarded as a major tool in creating a favorable area of economic growth and sustainable development.

The European Union and the euro zone expanded gradually and the progress of macroeconomic harmonization process was obvious in the last decade. However, as Rozmahel, Grochova and Litzman (2014) had been shown, significant differences regarding monetary and fiscal policy of the European countries are remarkable: while the European Central Bank applies the same measures of monetary policy for all countries, waiting also the countries that wants to adhere to adjust their policies in accordance with criteria convergence supported by the pact of Maastricht, fiscal policies are still controlled by national authorities.

At the European Union level, the fiscal policy is based on the principles of the single market; each country is free to adopt its tax regime, closely related to the degree of economic, social and military development.

The tax rates in European Union

Developments and differences in terms of taxes in European Union countries outlined through graphical representations and interpretations of different points of view, are due to the application of tax rates. In this sense, the two methods represented by the single rate tax or progressive rates of taxation, managed to make their mark directly on each fiscal policy and indirectly on the degree of fiscal requirements, level of economic and social development .

There is no secret that the fiscal policy often can not be neutral , but more than this can divide the people into two social categories. Although, formally, we are all paying taxes, M.N. Rothbard (2006) argues thate there are social categories that contribute more to the state budget, and here we refer to those who earn incomes in the private sector, compared to those that are paid from the public budget. Over time, hoping to unite the population in terms of fiscal matters, the authorities had chosen different methods of taxation.

Over time, the tax sustem had sufferd significant legislative interventions, manifested in different forms in each country, in order to put their mark on the economic and social space. In recent decades there have been many tax reforms in Europe, especially if we consider the recent economic crisis triggered worldwide. A tax form drew the attention especially in the last ten years: the flat tax .

Around the world, the debate between progressive and proportional taxation started, in 1983, by Hall and Rabushka's theories. The two economists had promoted and defined flat tax as the simplest and most beneficial thing for a market economy: the same tax rate applied no matter the income of an individual or a corporate profit. Even when launching this theory, the flat tax rate was not implemented, represented the subject of many academic and political debates worldwide.

In Europe, the effect of this theory became increasingly felt in the past 10 years, when many post-communist states adopted the flat tax. The main purpose of this implementation was to reduce tax evasion. The supporters of the flat tax, considered it a fair tax system, which encourage the consumption, the aim being to stimulate the supply. In most states, as in the case of Romania, this has not happened: the flat tax led to accelerated growth of consumption with the widening of the current account deficit.

On the other hand, progressive taxes are designed to collect a higher proportion of tax revenue from the rich to the poor, thus reducing income inequality compared to the taxable available. This policy was supported for a long time by economists as Karl Marx and Adam Smith. In the same time, Duncan and Peter (2012) demonstrated that the proponents of liberal doctrine considered that this tax system can only deacrese the income level, because people are forced to turn to other states, with different fiscal policy and with a more relaxed tax system.

These different fiscal approaches and the gradually increase of the European Union area , encouraged the presence of a more active tax competition. The phenomenon of tax competition between states occurs when there is a variation in tax rates and people can choose between them; in this situation there are two types of reaction from Member States: reducing the tax burden by reducing tax rates, which involves also the reduction of the government revenues or keeping the same level of tax rates and use the accumulated resources to enhance the attractiveness of the national territory by offering a rich package of public goods and services. In both cases, the state is seen limited, forced to give up to some revenues not to lose some categories of taxpayers which can migrate or invest the money somewhere else, while the companies are using the tax competition as an opportunity (Vuta & Lazar, 2008).

This „speculative" behavior in terms of tax, was also encouraged by the expansion of the Euro Zone and was a well known consequence of the single European market creation. Both approaches for taxation, progressive or proportional, presents obvious advantages and disadvantages whose effects were felt over time in European economies.

In Table 1 are shown relative advantages and disadvantages of progressive taxation. Progressive taxes rates are often essential for a fair distribution as a "tax burden". In this regard the imposition of differentiated rates can be done taking into account the economic strength of the taxpayer (income / wealth), but also of the social background (the taxpayer is maintaining a large family, it is part of a disadvantaged group etc.). But in the same time, excessive differentiation can create difficulties regarding collecting system, and sometimes can encourage the tax evasion.

Tabel 1. Advantages and disadvantages of progressive tax

Advantages of progressive tax	Disadvantages of progressive tax
Encourages people with low income	Discourages people with high income
Encourages consumption	May cause increase in tax evasion
May increase the fiscal budget	Encourages the companies to migrate in states with a relaxed tax system

Although the flat tax was heavily promoted worldwide in the `80, in Europe entered with small steps and was adopted especially in the Eastern European countries, which believed in the benefits of this system supported with famous economic theories .

Tabel 2. Advantages and disadvantages of flat tax

Advantages of flat tax	Disadvantages of flat tax
Decreases the tax evasion	Discourages small enterprises
Promotes a simplified tax system	Promotes a regresive tax system
Creates favorable business environoment	Causes reduced fiscal flexibility

Numerous debates and financial analysis on tax rates were based on a simple question, but with no clear answer up to now: "What kind of tax system is more appropriate: progressive or flat?". After long research and different approaches some economists think that the choice of the tax system can not be the same for each state, there is no generally valid answer. Moreover, this choice has a fairly large political implication. This may represent a relevant explanation for the fact that the flat tax was strongly adopted in the last decade by post-communist countries that have followed in the `90 similar fiscal and monetary trends .

In fact, as Marinescu (2009) had been shown, not how taxes are collected is the most important thing for a state, but the income obtained by applying the tax rates, because through the dimension of this level may or may not be covered budgetary costs, may or may not be ensured social security, can or can not be increased the degree of economic development.

The flat tax in European Union

As we highlighted above, the tax system based on a flat tax has grown in Europe in the last decade. The first country that introduced a flat tax (26%) in Europe was Estonia, in 1994. In 2009, the rate was reduced to 21%. Figure 1 represents the European Union Member States, where states are divided by the applied tax system.

From Figure 1, it can be seen that the countries with the lowest tax rates are Bulgaria (10%), Lithuania and the Czech Republic (both 15%). In contrast, there are Latvia (25%), Slovenia and Estonia (both 21%). Romania, Hungary and Poland practice an average tax rate, of 16% and 19% respectively. It is worth to mention that other European countries such as Russia, Macedonia, Munetnegru, also post-communist countries, still practice a proportional tax system introduced after 2000. Slovakia, dropped the progressive tax rates in 2004, but in 2013 returned to the same system.

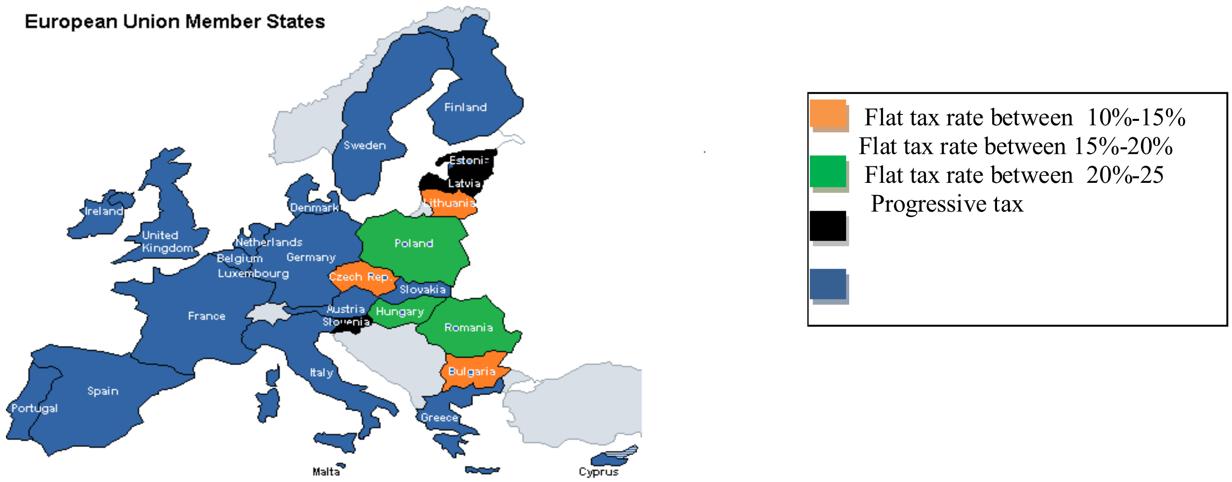

Figure 1. European Union Member States, divided by the applied tax system

The main reasons why these countries have decided to adopt proportional tax rates were: reducing tax evasion and attracting foreign investments. States in Central and Western Europe were not faced with these two problems to a such high degree, considering the best alternative the progressive taxation.

The motivation of adoption the porporţional tax system was an appropriate one in terms of tax, but the question raised by economists was: ”The flat tax had the expected effects?”. To try to find out the answer to this question, we will compare the budget revenues in times of progressive taxation to the level of budget revenues after switching to flat tax. Theoretically, if we consider the benefits of proportional tax system, Member States should record growth from changes due to the reduced tax evasion and increased foreign investment.

In Figure 2 are plotted the budget revenues levels as a percentage of gross domestic product in four European countries that have introduced flat tax after 2000 year: Romania, where the flat tax was introduced in 2005, Bulgaria and Czech Republic, where the flat tax replaced the progressive one in 2008 and Hungary, where the tax system changed in 2011.

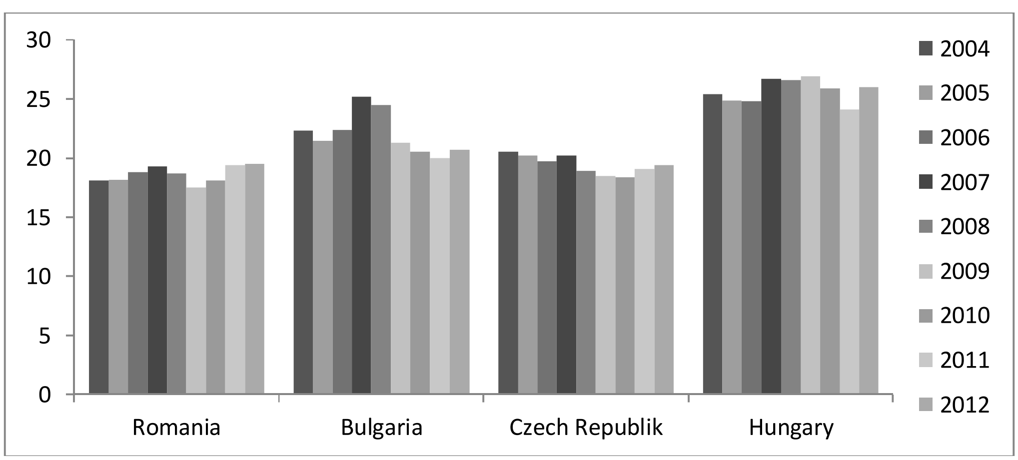

Figure 2. Total taxes as percentage of total taxes in GDP (Eurostat, 2013)

In Romania, after introducing the flat tax in 2005, there has been a slight increase in 2006 and 2007 (with 0.03% and 0.06%). Then followed a downward trend in the next two years, and in 2011 and 2012 registered again an increase of 0.06% and 0.07% compared to 2004.

In Bulgaria, we can observe a decrease of the level of income taxes after the introduction of the flat tax in 2008. One explanation might be the time when the tax system was changed (when the economic crisis hit) but also the low tax rate adopted in comparison with other countries (10%). However, it is observed in the last two years analyzed, 2011 and 2012 a slight increase, but without reaching the level collected in 2007.

Like Bulgaria, also the Czech Republic adopted the flat tax system in 2008, but the income level did not decrease so visible. Moreover, in 2011 and 2012, the collected revenues are close to those collected before the crisis.

Hungary is the last country that gave up to the progressive tax, in 2011. It can be seen that showed a visible decline in 2011 but then in the following year reached a higher level of revenues than in 2010, the last year of the progressive tax system.

Through an analysis of the whole, we can say that the flat tax did not had the expected effects. If the tax evasion would have been decreased or the mentioned countries would have benefit for foreign investment, the budget revenues should have been increased, but that did not happen.

Of course, an extremely important factor of this was the economic crisis, which brought salary cuts, decreases in consumption and in companies profits. And this can also be seen in Figure 2, because in all Member States captured graphically, starting with 2009, when the financial crisis was the most strongly felt in Europe, there was a decrease in revenues. In the lasts years we can see a recovery regarding the level of the collected taxes ans it is worth to mention that all analyzed countries recorded higher revenue share of taxes in GDP in the last two years analyzed in comparison with previous years.

One of the reason may be the changes brought in the indirect tax system; regarding the structure of European tax systems, it's known that the Eastern European states largely based their budget revenues by collecting indirect taxes, while the countries of Central and Western Europe turns its majority share to social contributions collected from employees / employers, and to direct taxes.

Proving that it is not random for these four countries to base their tax system structure on indirect taxes, in Table 3, can be viewed standard VAT rates applied in 2009, 2011 and 2012 in Romania, Czech Republik, Bulgaria and Hungary.

Tabel 3. Standard VAT rates available in 2009-2012 period (European Commision, 2014)

Country	2009	2011	2012
Romania	19%	24%	24%
Bulgaria	20%	20%	20%
Czech Republik	19%	20%	20%
Hungary	25%	25%	27%

It is noticeable that Romania and Hungary have increased the rates of value added tax in the years 2011 and 2012. This change had a positive impact on tax collection, leading to their growth as percentage in gross domestic product. Czech Republic also increased in 2010 VAT rate by 1 percentage point, but like Bulgaria, also modified the reduced VAT rate by 4 percentage points in 2010, as shown below.

Tabel 4. Reduced VAT rates in 2009-2012 period (European Commision, 2014)

Country	2009	2011	2012
Romania	5%/9%	5%/9%	5%/9%
Bulgaria	7%	9%	9%
Cehia	9%	10%	14%
Ungaria	5%/18%	5%/18%	5%/18%

The change of the value added tax rates is most visible in the analysis of indirect tax share of GDP. In the analyzed period is observed their upward trend in the four Member States of the European Union. This is shown in Figure 3.

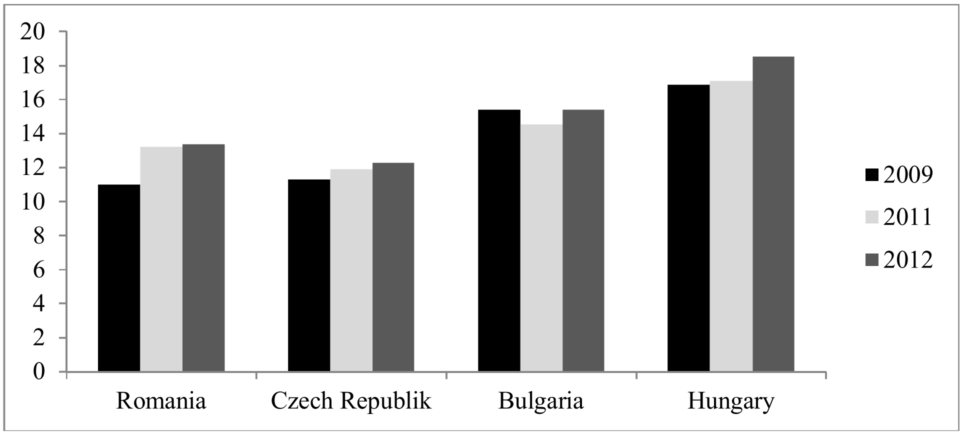

Figure 3. Inidrect taxes as percentage of GDP (Eurostat, 2013)

Looking at the chart above, we see that the budget revenues increased along with the the increase of the VAT rate. Romania increased its standard VAT rate from 19% to 24% in 2010 and Hungary in 2011 from 25% to 27%. Czech Republic had a significant increase in the VAT reduced rate in 2012 from 10% to 14% and Bulgaria in 2010 from 7% to 9%.

These observations lead to the conclusion that the introduction of the flat tax has not had the beneficial effects antcipated for post-communist states. The "underground economy" was not discourgaed by introducing the flat tax and the attracted foreign investment by charging reduced rates of taxation were probably overshadowed by the financial crisis of years. However, we could see an increase in revenue collected from the state budget in the past two years analyzed, but it comes after measures to increase the share of indirect taxes.

Current aproeaches for European taxes

Although the proportional tax system began to be present in Europe quite late, enough time has passed so that we can interpret the effects of the flat tax in the european fiscal environoment. If it were to relate only to this change , we can say that the effects on fiscal and economic matters were not so visible.

Moreover, there are some European countries that gave up to the proportional tax system. The latest change in this regard was made by Slovakia. If in 2004, the fiscal system was aligned to the model adopted by most of the East European states, in 2013, Slovakia has returned to progressive taxation system. The main argument for the change was the regressive character of the flat tax (regardless of income is applied the same rate). As Peichl (2013) mentioned, this change came along with changes in the political class. Also, Iceland, Serbia and Ukraine gave up to the proportional tax system in 2010-2011 period, because its effects were not positive in tax policies.

Also in Romania there are discussions about giving up to the flat tax and adopting again the progressive taxation since 2016. Authorities believe that this change will be beneficial to increase revenues, which will reduce the budget deficit.

It is possible that after an attempt to stabilize the tax system by adopting the flat tax, Eastern European countries to resort to the methods of previous tax? This may be possible if we take in consideration that the proportional system effects were not as expected, the economic crisis has destabilized the fiscal policies of states and not least the objective of economic development following the model of the countries of Central and Western Europe is becoming more pronounced.

Conclusion

After the analysis made with this paper, we can say that it was not discovered yet a single tax system which should be applied in all Member States. Every fiscal policy and each type of tax rate applied comes with advantages and disadvantages, but countries have to choose the best option adapted to the financial and social needs of the economy.

Regarding the comparison between progressive and proportional tax, we can conclude that the flat tax concept was embraced by European post-communist countries, expecially during the last decade. Their main expectations were reducing tax evasion on the one hand and attracting foreign investments on the other hand. Following statistics, we observed that the effects were not as expected, or the changes occurred in a very small number, too small to stabilize the fiscal and economic environment. This might be explained by the fact that the adoption of a tax system may not be enough to stabilize the economy of a state.

After the crisis, countries that have adopted the flat tax, started to take in consideration a return to progressive taxation. In this respect, in the European Union, Slovakia has made this change after other European countries such as Ukraine and Serbia did the same. Currently, such a change is expected in Romania, starting with 2016, in order to try to achieve two important objectives: fiscal stabilization and reduction of the budget deficit.

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