

FLAT TAX for FINLAND

**A simple and fair tax system
that promotes growth**

Martti Nyberg



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FOREWORD

“Playing With Numbers: A Flat Tax for Finland”

Dr. Martti Nyberg, an economist at the Finnish Business and Policy Forum, EVA, has proposed a tax reform plan for Finland. He sets forth a convincing case that shifts the tax base from income to consumption, reduces marginal tax rates on individuals and enterprises, and improves incentives to work, save, and invest. If enacted, it would enhance Finland’s international competitiveness.

In his report, Nyberg first describes some of the disadvantages of the current tax system in Finland. He then explains the economic advantages of a consumption-based flat tax. A tax system based on consumption exempts all new investment from the tax base every year. This provision increases the stock of capital that makes workers more productive and enables them to earn higher incomes.

Nyberg builds on the flat tax plan I developed with my Stanford colleague, Robert E. Hall, reviews the work of others, and develops an appropriate model for Finland. He focuses on three important features of the new system: simplicity, fairness, and growth.

Taking as his starting point the Hall-Rabushka flat tax, Nyberg proposes a flat-tax plan in which all Finns are winners. The flat tax has proved successful in each of the ten countries that have adopted it since 1994 in Central and Eastern Europe and Central Asia. Nyberg demonstrates that every Finn would enjoy an increase in his after-tax income compared with the current Finnish system. By shifting the tax base to consumption, thereby broadening its coverage, he is able to reduce tax rates for individuals and firms.

Adoption of Nyberg’s model would improve the performance of Finland’s economy. It would improve incentives to work, save, and invest, and increase entrepreneurial risk-taking, thereby resulting in a higher standard of living. It would do so without eroding the ability of the government to finance vital public services.

Nyberg’s plan satisfies the political conditions of comprehensive tax reform by creating a nation of winners. It satisfies the economic conditions of reform by increasing economic efficiency. It satisfies the ethical consideration of fairness by treating all taxpayers equally. All in all, Nyberg’s flat tax is the right answer for Finland. It can and should be adopted.

Alvin Rabushka
Hoover Institution
Stanford University

IN BRIEF

The purpose of this report is to lay out an alternative system of taxation that is substantially simpler and more efficient than the current system in place in Finland. The objective in establishing a 29 per cent flat tax on wages and business income is to enlarge the tax base and increase the disposable income of wage earners and pensioners.

Under the new system, nearly half a million Finns would pay no tax at all on earned income, which is fair, because according to the general sense of fairness, no tax should be paid on the lowest incomes. Everyone could earn 7,000 euro per year and not pay taxes on it. The tax burden on wage earners and pensioners would be reduced by 3 billion euro; this would decrease the gap in purchasing power between Finland and the other advanced states of Europe.

Moreover, Finnish gross wages are lower in many sectors than in Western Europe, and high taxation increases the difference in net wages. Because of the current income tax rates, it is very difficult to attract highly skilled workers to Finland from abroad to take long-term positions. Also, there is the risk that Finns will leave the country to seek a higher net income.

We must also encourage businesses to stay in Finland, and both corporate taxation and owner incentives play a role here. Currently, businesses pay dividends to their owners from income on which corporate tax has already been paid. The owners then pay capital income tax on the dividend income they receive, which means that the same income is taxed twice. The model presented in this report does not tax dividends and gains from sale of assets twice.

Increasing production and purchasing power will also promote the attainment of employment targets. If we really want to lower unemployment in Finland, we must create new jobs in the service sector. This can be achieved by increasing the disposable income of wage earners, which will allow them to purchase more services.

The only tax deduction included in the model is the basic 7,000-euro deduction to which everyone is entitled. It proposes the exclusion of all other tax deductions, including the right to deduct interest paid on home loans. The proposal is a radical one, but also justified, because every tax deduction increases the general tax rate.

Capital income comprises mainly dividends, rental income, and gains from sale of assets. In personal taxation, the model eliminates the tax on capital because it distorts the behaviour of both wage earners and businesses.

Under the proposed model, Finnish wage earners would have 3 billion euro more in disposable income. The objective of the report's proposal is to be

neutral in terms of income tax, in other words, it would generate the same tax revenue as the current system. This is why it proposes a business tax to replace the current corporate income tax. It would generate 3 billion euro more in revenue than the current corporate tax. The business tax is, however, much more than the current corporate tax, because the proposal would eliminate deduction rights on existing capital while new investments would be fully and immediately deductible. Moreover, the former capital income tax would be partly included within the scope of the business tax, which would also include entities other than businesses that are engaged in business, and it would have a broader tax base as businesses would no longer be able to deduct interest. In addition, the business tax would cover benefits provided by employers to their employees which are not taxable under the current system. It is also possible that the business tax would bring many activities that are currently within the sphere of the grey economy into the mainstream.

The proposed model would have a positive impact on economic activity, the supply of labour and investment. Elimination of the tax on capital and the lower marginal tax rates would result in changes in the behaviour of individuals and businesses that have to do with the supply side of the economy; these changes would have a positive impact on tax revenue.

It is obvious that the model drafted in this report requires further investigation and specification. Furthermore, it is hard to imagine radical reforms without long periods of transition in some cases, which in turn would negatively affect tax revenues. In practice, implementing tax reforms is hampered by various technical and political difficulties, which will be dealt with only cursorily in this report.

Indeed, the ultimate purpose of this report is to introduce background information on the ideological issues concerning the flat tax to the public debate. This is amply justified by the fact that, in addition to having been a subject of many years of considerable academic interest, the flat tax has been introduced in many countries near Finland and there is growing debate in other European countries as well.

I would like to extend my gratitude to everyone who has discussed the subject with me for their valuable comments. The idea that led to the subject was suggested to me by Professor Alvin Rabushka, with whom I have had the opportunity to collaborate during the project. Of course, I take full responsibility for the content of the report.

In Helsinki, 10 April 2006
Martti Nyberg

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1 Introduction

Upon examination, Finnish taxation is so complex that it is difficult to believe that any committee of experts working from a clean slate could propose such a complicated system. Could we not have a tax system that looked like someone had designed it?

1.1 Current system

We have arrived at the current system for a variety of reasons. On the one hand, leaks in the system have been patched to satisfy the wishes of various interest groups. On the other, Finland has had to react to international tax competition. The system is neither based on a philosophy of taxing income nor consumption, but is instead a hybrid of sorts combining something of both. The following are what motivated me to propose the reforms presented in this report. In particular, the current system of taxation:

- is strongly geared to income redistribution, instead of to efficient collection of taxes to finance the public sector;
- directs the behaviour of both individuals and business in a way that leads to an inefficient allocation of resources and slower economic growth;
- penalises people for saving by preferring consumption today instead of sometime in the future;
- demonstrates that granting tax benefits to only certain activities or taxpayer groups is usually not expedient. It would make more sense to aim at a broad tax base and accept deviations only when tax exemptions, deductions, or refunds justify the fact that other taxpayers will have to pay more;
- encourages some people to engage in the grey economy. This is caused both by the complexity of the system and the heavy tax burden on certain taxpayers;
- means that tax laws are amended continuously, which makes it very difficult to plan ahead.

1.2 A new tax system

The objectives of the new tax system are simplicity, fairness, and promotion of economic growth. Some may think that they reinforce each other or even conflict with each other. If so, compromise would be necessary and most likely at the cost of simplicity. In the following, however, I propose that despite frequent ideological tension between these goals, all three can be attained together and with the same tax system. This report presents a model of a flat tax¹ on wage and business income. It is similar to a tax on consumption and it has the following objectives:

- A radically simplified tax system for wage earners and businesses.
- A reduction in tax rates in all income brackets for wage earners and a system of progression implemented by introducing a 7,000-euro deductible. All income above 7,000 euro would be subject to a 29 per cent marginal tax rate. Since the average tax rate would hence increase with income, the system would be progressive.
- Because of the tax-exempt 7,000 euro, all other deductions, including the right to deduct interest paid on home loans, would be eliminated.
- A business tax similar to the current corporate tax would be retained but capital income tax would be abandoned. All businesses would be treated similarly regardless of their type or form. The new system would abolish the current system of investment depreciation deductions and the tax-deductibility of loan interests. Instead, full investment write-offs would be made immediately, when the investment is made.

Otherwise the system would stay the same and would not have any effect on indirect taxes such as the value added tax or social security contributions. In other words, the proposed reform would affect only direct taxes.

¹ The following have voiced their opinions on the flat tax in Finland: Pentti Vartia, Kari S. Tikka, Jorma Sipilä, Osmo Soininvaara and Jaakko Kiander. In a speech given at a conference organised by the Association of Finnish lawyers in October 2005, Professor Tikka predicted that by 2010, Finland's position in the competition for knowledge capital will have led to a structural income tax reform which results in the flat taxation of income (Kari S. *The future of wage taxation, 39th conference of lawyers* [Palkkaverotuksen tulevaisuus, 39. lakimiespäivä, not available in English], pp. 25–30). Tikka has also discussed the issue of flat tax in an article entitled *A good income tax system: progression or flat tax?* (Hyvä tuloverojärjestelmä progressio vai tasavero?, *Kansataloudellinen aikakauskirja* 3/2004, pp. 322–328; not available in English).

1.3 The impact of changes

Can we expect these changes to promote the attainment of the targets of the new tax system set in the beginning?

Simplicity will increase when:

- All earned income (in excess of the basic deductible sum) would be subject to the same marginal tax rate, which would simplify tax administration.
- All types and forms of businesses would be subject to the same business tax.
- Entrepreneurs would have little need to ponder how much to pay themselves in wages and how much in capital income.
- No one would have to waste time with deductions and receipts.

Fairness will increase when:

- Everyone would understand the simple rules of taxation, which would place them at a more equal standing with the tax authorities and improve their confidence in them.
- Business profits would no longer be taxed twice.
- Tax deductions available only to particular groups would be abandoned.
- There would be less tax planning, which only some taxpayers can do in the first place.

Chances of economic growth improve when:

- Wage earners' marginal tax rates fall substantially.
- Saving would no longer be taxed. This means that in terms of taxation, consumption would be equally attractive in the future as it is now.
- Dividends and capital gains of assets would no longer be taxed twice.
- Taxation would not distort the behaviour of individuals and businesses when they decide on what is best for them financially.
- The resources that businesses expend on tax planning could be allocated to more profitable activities.
- All forms of financing business activities would be treated equally.
- Businesses would leave the grey economy and engage in lawful business activity.

- Wage earners would make themselves more available to employers because their disposable income would increase.

The message of this report is that adopting a flat tax would boost the Finnish economy. It would increase the incentives to work, save and take entrepreneurial risk. It would also steer investments towards activities that produce goods and services instead of avoiding taxes, which makes better economic sense. It would keep the highly skilled manpower in the country and attract highly skilled foreigners to Finland. It would also be a strong incentive for Finnish owners to remain in Finland because it disposes of the double-taxation of dividends. It would also create jobs in the service sector, which appears to offer the best way of reducing unemployment.

The goals of the flat tax model proposed here is that each and every wage earner would have more of his/her income left after taxes. Corporate income would no longer be taxed twice since dividends and profits from the sales of assets would no longer be subject to tax. The model is based on taxing consumption: people pay tax according to what they take out of the economy (consumption) instead of what they put into it (production).

Next, I will examine developments in taxation in Finland and abroad in the last few decades. I will pay special attention to the link between taxation and employment and the impact of tax cuts on tax revenues. I will also discuss the fact that globalisation is in the process of changing economic circumstances in a way that is apt to intensify the distorting effects of taxation.

2 International and national perspectives

2.1 Developments involving taxation in OECD countries²

Since the mid-1980s, all OECD countries have implemented substantial tax reforms. The governments of the various countries have sought to develop tax systems that are fairer, more efficient, more competitive, and simpler.

Fairness is a complex concept. In taxation, for example, it means that taxpayers in similar circumstances are treated similarly and that no group is allowed to shift its tax burden to another.

Attempts have been made to increase fairness by expanding the tax base and removing various tax deduction rights and tax easements.

But fairness also means that honest taxpayers should not have to pay for those who evade their taxes. If people are convinced that all taxpayers are treated equally, they will have more respect for the tax authorities and be more willing to pay taxes.

The need for more efficient and competitive taxation systems has been widely recognised. Because of globalisation, capital and those with the best skills consider differences in taxation between countries before deciding on where to locate. Consider, for instance, the European debate on outsourcing, or how there is no difference for an architect between working from Helsinki or Tallinn. And this applies not only to businesses and certain professions and occupations. Even consumers can participate in the global market. The worldwide market for digital music is a good example.

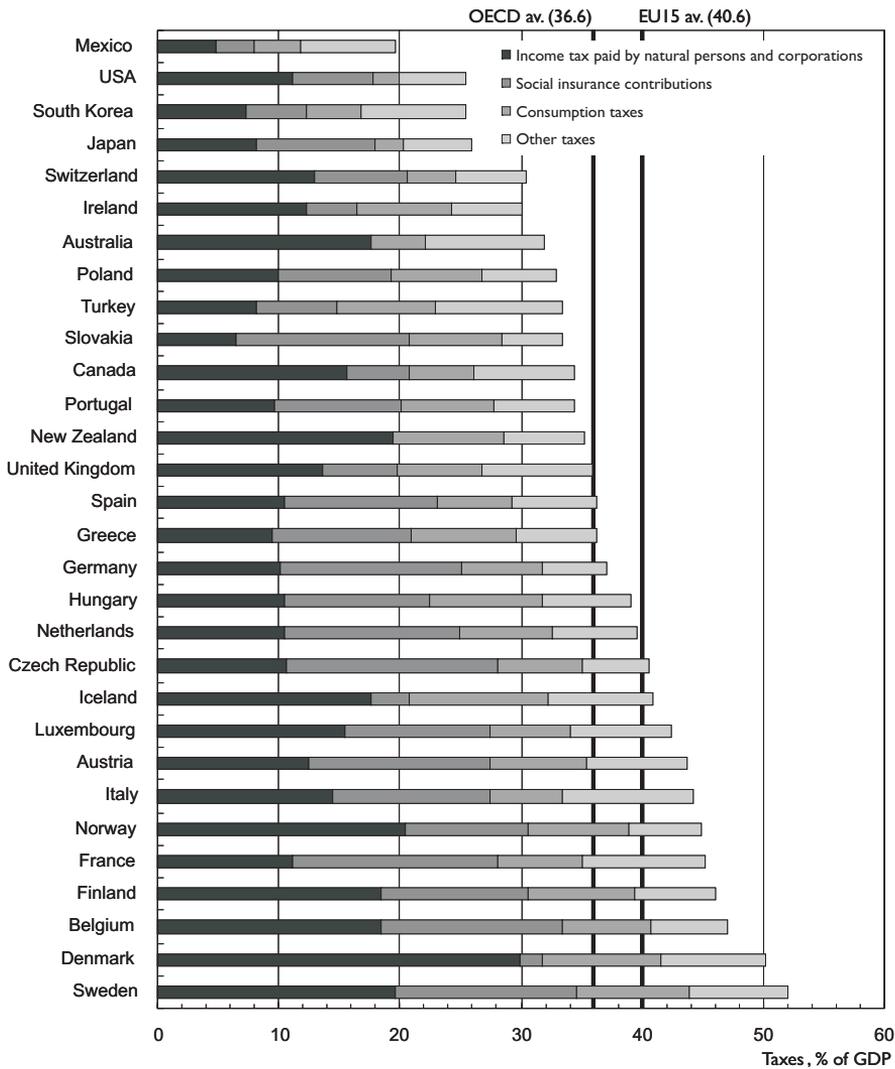
This means that a growing portion of the tax base is subject to tax competition, and nearly every finance minister keeps emphasising how important it is to have a competitive tax system.

² The OECD report is based on a presentation given by Jeffrey Owens in San Francisco on 31 March 2005, entitled *'Tax Reform: An International Perspective'*.

Governments want to use taxation to create an environment within the borders of their country that encourages risk taking, increases investment, and improves work incentives.

In principle, governments everywhere are in favour of simpler tax systems. The problem is how to achieve that kind of system in today's complex economic environment. Some think that demands for simplicity endanger fairness.

Figure 1 Total tax burden in OECD countries and its distribution over different taxes



Source: OECD.

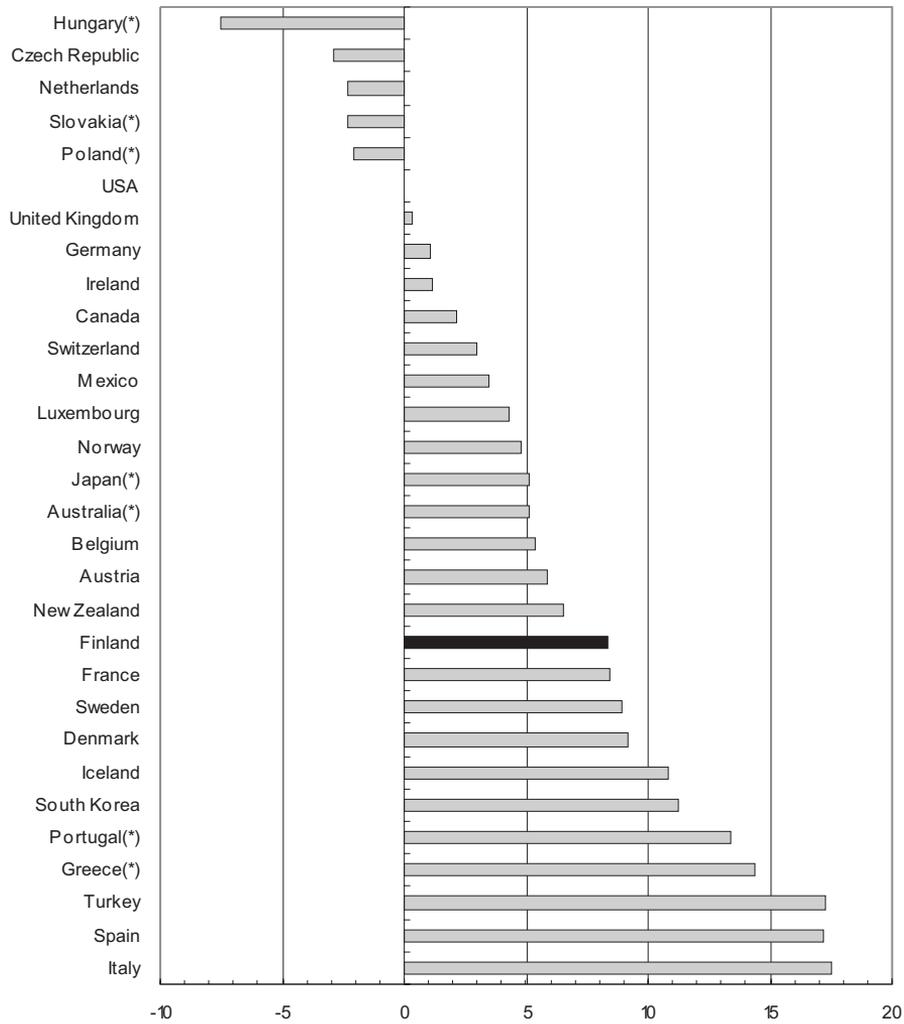
To attain these targets, many OECD countries have cut corporate and wage taxes and broadened their tax base by removing the various tax easements, deductions, and loopholes that make tax planning possible. Moreover, a low, broad-based tax on wage income is not only simpler; it may also be more just and cause less distortion.

This has also meant movement towards a lower progression, which has been achieved by reducing the number of income brackets in wage income taxation. In most OECD countries, there are currently fewer than five income brackets.

Figure 1 shows how the total tax revenue as a percentage of the gross national product varies between 50 per cent in Sweden and 25 per cent in the USA. It also shows how tax revenue sources differ between countries. In the United States, the share of indirect taxes is significantly lower than in the other OECD countries.

Has this situation been permanent? Figure 2 shows how the change in the tax as a percentage of the GNP has evolved in different countries. It is noteworthy that the United States and the United Kingdom have managed to avoid the rising trend of many other OECD countries. In the last 30 years, the GDP share of taxes has increased rapidly in Europe. The fact that the United States has gone the other way may be the result of inter-state competition, the lack of a value-added tax, a different attitude to the role of the government, and alternative ways to finance items such as education and pensions.

Figure 2 Change of tax contribution to GDP in OECD countries from 1975 to 2003



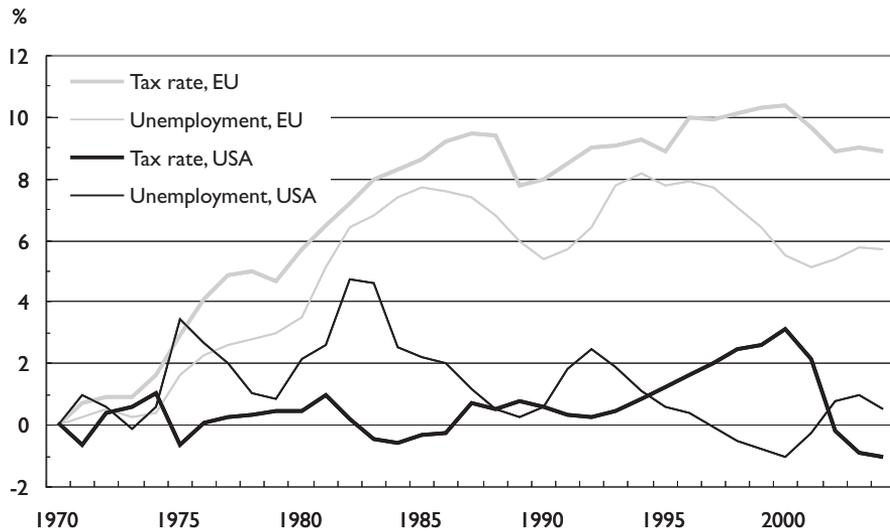
Source: OECD.

2.2 The impact of taxation on employment and public finances

Do the differences between tax rates in some countries also explain the differences between macroeconomic variables such as unemployment?

Let us have a look at historical tax burdens in Europe and the United States. Figure 3 shows how much the trends have differed³. It also shows how tax rates and unemployment increased at the same time in Europe in the 1970s and 1980s. In the United States, where tax rates are low, however, employment has been much higher. The oil crises of the 1970s and the rise in real interest rates in the 1980s hit the economies on both side of the Atlantic. In Europe, their effect was combined with an inflexible labour market, which led to an increase in

Figure 3 Cumulative changes in tax rate and unemployment in the EU countries and the United States from 1970 to 2004



Source: Rolf Mayry's estimates are based on figures from the following statistics: Bureau of Economic Analysis (BEA), U.S. Department of Commerce, Eurostat, OECD and the Research Institute of the Finnish Economy (ETLA).

³ Suvanto, Antti (2002): Euroopan rakenteelliset jäykkyydet, *Valtioneuvoston kanslian julkaisusarja 2002/4*, p. 62.

unemployment. The response was to increase public spending, which meant that taxes had to be raised. This in turn led to demands for higher wages and further increased unemployment.

Taxation has a negative effect on job creation. When people are taxed heavily, as is currently the case in Europe, they are left with less money to buy goods and services, start businesses, and hire workers. This hinders economic growth. Taxes form a ‘wedge’ that raises the price for buyers and lowers the compensation received by sellers. In other words, the tax wedge is harmful to employment and entrepreneurship.

Taxation has an especially problematic impact on how much we work and how well we do our jobs. It is equally relevant to whether we work at all or to how much we are willing to work. Table 1 shows production, labour supply, and productivity in the G7 countries compared with the United States during two periods. On the one hand, it is important to note the large difference in

Table 1 Production, labour supply, and productivity

In certain countries in 1993 to 1996 and 1970 to 1974, in relation to the United States (USA=100), people aged 15 to 64

	Country	GDP per capita	Hours of work per capita	GDP per hours of work
1993-1996	Germany	74	75	99
	France	74	68	110
	Italy	57	64	90
	Canada	79	88	89
	United Kingdom	67	88	76
	Japan	78	104	74
	USA	100	100	100
1970-1974	Germany	75	105	72
	France	77	105	74
	Italy	53	82	65
	Canada	86	94	91
	United Kingdom	68	110	62
	Japan	62	127	49
	USA	100	100	100

Source: Prescott, Edward C. (2004): Why Do Americans Work So Much More Than Europeans?, *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 28, No. 1, pp. 2-13.

labour supply (number of hours worked) in 1993–1996 between the United States and Germany and France. On the other hand, we can see how an employee in the United States produces 40 per cent more than in Europe. This discrepancy is explained almost entirely by the difference in total hours of work and not by productivity (production per hour of work).

The situation was very different in 1970–1974. No change has taken place in worker productivity. During the earlier period, production in Europe was 70 per cent of that in the United States, the same as in 1993–1996. What is interesting is that the lower production in Europe was not caused by a low labour supply (hours worked), as is the case for the 1993–1996 period, but by lower productivity. In fact, in 1970–1974, Europeans worked longer hours than Americans⁴.

Prescott blames the difference in production entirely on Europe's high marginal tax rate: it is roughly 60 per cent in Europe, against 40 per cent in the United States. According to Prescott, the fact that tax rates have increased since the 1970s has simply decreased the labour supply, resulting in this discrepancy. Hence, the low supply of labour caused by taxation is the principal reason for the observed difference in the standard of living. Prescott calculates that in France, for example, GDP per capita could be 15–20 per cent higher had the tax burden remained on the level of the early 1970s⁵.

Using international material, Juha Tarkka and Mikko Spolander have studied the link between taxation and employment. They estimate that there is a strong and statistically very significant negative correlation between labour supply and tax rates. They claim that a tax rate decrease of one percentage point would increase the average weekly working time of 21.5 hours by 1.2 per cent⁶.

There are other studies, however, which estimate that labour supply reacts less to changes in taxation. In a recent study, Alberto Alesina and others conclude that people appreciate leisure time more in Europe than in the United States⁷.

⁴ Prescott, Edward C. (2004): Why Do Americans Work So Much More Than Europeans?, *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 28, No. 1, pp. 2–13.

⁵ Suvanto, Antti (2002): Verotuksen vaikutus työllisyyteen, *Valtioneuvoston kanslian julkaisusarja*, 13/2004.

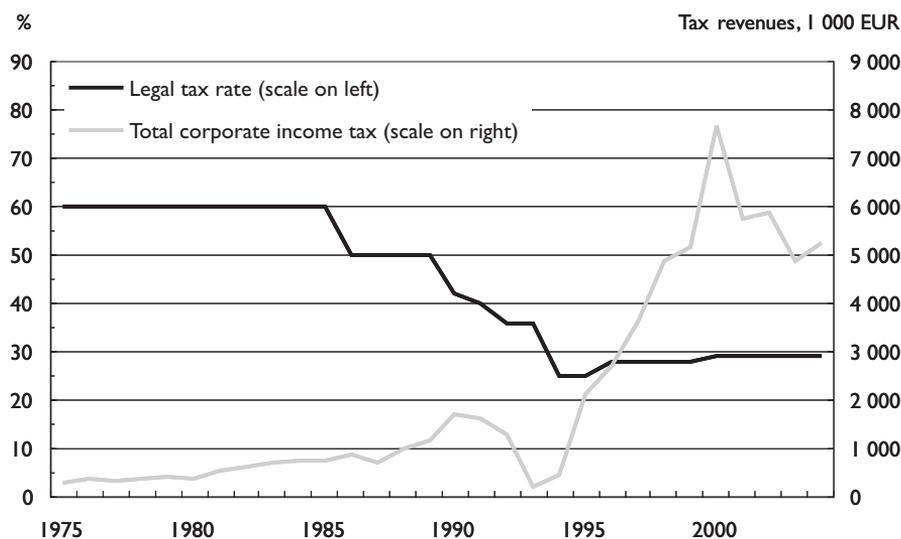
⁶ Spolander, Mikko & Tarkka, Juha (2005): Verotus ja työllisyys – kansainvälistä vertailua, *Euro & talous*, 2005/1.

⁷ Alesina, Alberto, Glaeser, Edward & Sacerdote, Bruce (2005): Work and leisure in the U.S. and Europe: Why so different, *NBER working paper*.

They also draw attention to the impact of other factors such as strong unions and restrictive labour market legislation on employment trends, Olivier Blanchard also suggests that while taxation does have an impact on labour supply, Europeans have a stronger preference for free time than Americans⁸. Prescott, however, is sceptical of the difference between the preferences of Europeans and Americans concerning leisure time. Why were the differences not observable in the 1970s, if Europeans really are fonder of their time off work than Americans? After all, the differences in labour supply emerged after the 1970s, when taxes increased in Europe.⁹

Changes in taxes affect tax revenues both directly and indirectly. The first impact is obvious: tax rates and the tax base have an effect on tax revenues. The second impact results from the changes in incentives and disposable income.

Figure 4 Corporate tax rate and tax revenues from 1975 to 2004



Sources: Statistics Finland, ETLA.

⁸ Blanchard, Olivier (2004): The Economic Future of Europe, *Journal of Economic Perspectives*, Vol. 18, No. 4, pp. 3–26.

⁹ See also Koskela, Erkki, Pirttilä, Jukka & Uusitalo, Roope (2004): Verotuksen vaikutus työllisyyteen, *Valtioneuvoston kanslian julkaisusarja 13/2004*.

They both have a positive impact on economic performance as well as on tax revenues. Hence, tax cuts will partly finance themselves by increasing economic activity.

When Finland lowered the corporate tax rate and removed the double taxation of dividends, substantial revenues were collected from businesses, as is shown in Figure 4. The corporate tax rate was cut by almost ten percentage points to 25 per cent in 1993, with significant results. Tax revenues increased ten-fold from 1992 to 2000 as a result of both fiscal and behavioural effects, which to at least some degree influenced business activity.

Before 1993, many businesses were engaged not only in their core business and financing, but also in real estate. Businesses would record break-even results, invest in real estate, and sell after a certain time, generating tax-exempt income. There was little incentive for small or even medium-sized businesses to show any profit due to the double taxation of dividends. When double taxation was abandoned, there was no motivation for investing in real estate, but there was an incentive to show a profit.

The new system, where owners no longer had to pay taxes on dividends that had already been taxed, was also a lot simpler than its predecessor; there no longer was a need to spend time on tax planning.

It is also important to remember that economies are based on people creating services and goods for themselves and each other. The purpose of businesses is to make goods and create customers. In other words, an economy is not just about ‘allocating scarce resources’ or ‘satisfying demand’. It is also about creating resources¹⁰, where individuals who often are exceptional innovators, inventors, and business people make the difference. The production lines of the risk taker Henry Ford turned a luxury item of the rich into a means of transport available to anyone. The iPod, an invention of Steve Jobs, led to the emergence of an entire new sector of industry. Wealth begets wealth. The tax burden must not be too heavy because to bloom, flowers need favourable conditions and so do people.

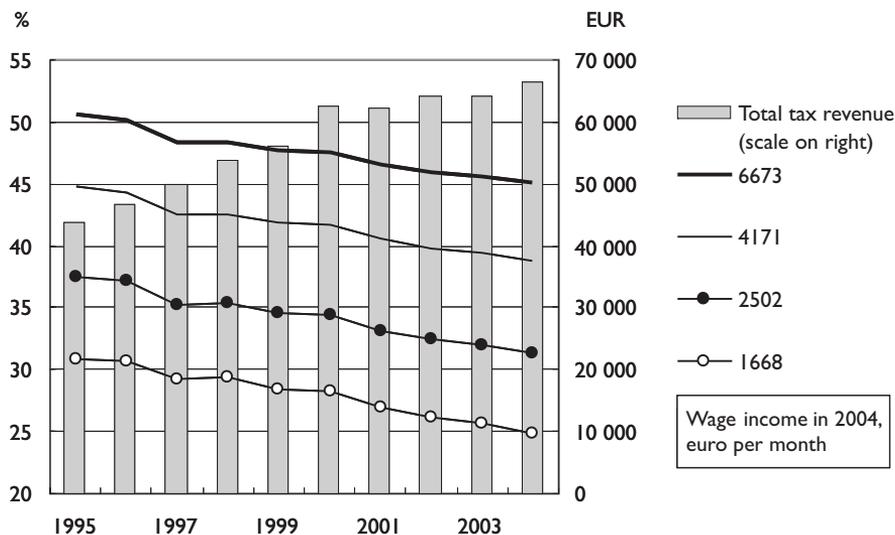
With substantially greater tax revenues from businesses, wage taxes could be reduced significantly. This does not seem to have weakened public finances significantly. Although the tax wedge on labour has been reduced by roughly 5

¹⁰ Further discussion in, for example, Drucker, Peter F. (2003): *The Essential Drucker*, and Forbes, Steve (2005): *The Flat Tax Revolution*.

per cent in terms of GDP, the total tax rate and total public sector revenue barely decreased. In addition, the public sector budget deficit has improved at the same time by a sum that corresponds to about 10 per cent of GDP¹¹. Figure 5 shows how Finland has been able to reduce the income tax rates of wage earners by an average of 5 per cent in all income brackets without reducing total tax revenues. This positive effect has also been influenced by economic trends, which have been favourable for a variety of reasons.

This is partly the result of the so-called dynamic effects of tax cuts. On the one hand, tax reductions bring tax revenues because they increase economic activity. People consume more and demand more services. More labour is needed to supply them. All this contributes to public finances in a number of ways, one of which is the increased revenues from VAT. An estimated 50 per cent of tax cuts are recovered through precisely these kinds of effects.

Figure 5 Income tax rates of wage earners on four wage levels and change in total tax revenues in 1995 to 2004



Sources: Taxpayers Association of Finland (TAF) and Statistics Finland.

¹¹ Kiander, Jaakko (2004): Verotuksen vaikutus työllisyyteen: Kokonaiskysynnän merkitys, *Valtioneuvoston kanslian julkaisusarja*, 13/2004.

In addition, there are also dynamic effects on human behaviour. When double taxation of dividends was discontinued, businesses changed their behaviour and this led to an increase in corporate tax revenue. And when work became more profitable, more work was offered.

In principle, a national economy could be in a position where an increase in tax revenues could be brought about by tax cuts. Conversely, it is possible that because of their negative economic impact, tax increases will not generate greater tax revenues. In any case, the dynamic effects of taxation mean that when tax rates are decreased, the decrease in tax revenues is smaller than in 'static' estimates (in which the impact on revenues is estimated on the basis of the income generated by the change in tax base and tax rate).

3 Why tax reform?

A natural starting point for a discussion on the structure of taxation is that tax authorities should collect the revenue needed to cover public expenditure in a manner that does minimal damage and distributes the tax burdens as fairly as possible.

3.1 Damage from taxation

Damage from taxation can take many different forms. In general, subjecting an activity or commodity to taxation reduces the attractiveness of the activity or the demand for the commodity.

This is evident when products with very similar properties are compared. If oranges are taxed more than apples, consumers will demand more apples and fewer oranges. It is also fairly obvious that if businesses are subject to higher taxes in Finland than, say, in Estonia, some will move to Estonia and it will be more difficult to attract new ones to Finland. This naturally also applies to people with top skills who compare net wages in different countries. On the other hand, if capital income from savings is taxed, people will consume more of their income now than in the future, which will reduce investment and cut economic growth in the long run. Moreover, when dividends are taxed twice, a business will behave differently than when they are taxed only once, which will also affect tax revenue. And higher wage taxes will mean a lower supply of labour.

The best way of avoiding these disadvantages is to have a broad tax base and low tax rates. Low tax rates also mean less progression.

This brings us to the dilemma of economic efficiency and income distribution, which makes designing an optimal tax system very difficult. In the most efficient system, taxes would be collected as a lump sum from every taxpayer. This is not the case anywhere, however, because it would be considered very unfair. Progressive income tax and capital income tax on the other hand, do not create incentives to work and accumulate wealth. By adopting the flat tax, with a basic allowance it can be done. The challenge faced by tax policy makers is to find a suitable compromise with which taxes can be collected as efficiently as possible without forgetting the significance of income distribution.

Differences in opinion concerning tax models often emerge because of the different emphases put on economic efficiency and fair income distribution.

3.2 Two camps

Although the opinions of the designers of different tax models differ in many other dimensions also, it is important to realise that such designers can actually be divided into two camps separated by two issues.

One camp is strongly in favour of a strong progression (including increasing marginal tax rates), and the other considers that equity in income redistribution leads to excessive inefficiency and therefore prefers a relatively low flat rate structure.

Furthermore, some feel that income is the best base for taxation, while others think consumption is the best target. These two issues are the principal differences between tax systems. The model presented in this report is a flat tax model based on taxing consumption.

3.3 What would tax reform achieve?

As early as 1651¹², Thomas Hobbes proposed that the government should tax consumption instead of wages because:

“For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idly getteth little, and spendeth all he gets...”

It is important to realise that there is no clear distinction between the concepts of taxing income and consumption. The principal difference is that income taxes always affect savings and investment in the form of capital income tax, for example, while a consumption tax does not affect them.

The economic consequences of introducing a consumption tax system have been studied with increasing interest for a quarter of a century.

¹² Hobbes, Thomas (1651): *Leviathan*.

Independent of each other, Kenneth Judd¹³ (1985) and Christophe Chamley¹⁴ (1986) have shown that in the long term, a tax system must not tax capital income if it is to be efficient.

The intuition behind this result is explained in the following. Bear in mind that an efficient system of taxation causes minimal change in the behaviour of people. Placing a high tax on apples and a low one on oranges would cause a substantial drop in the demand for apples, but if a low tax is placed on both, there would be no shift in demand between the two.

Let apples stand for consumption today while oranges stand for consumption ten years from hence. If you give up an apple today, you will receive a certain number of oranges in ten year's time. The number will depend on the interest paid on the money you saved by not eating the apple. With interest rates at 10 per cent, a euro saved now will be 2.60 euro in ten years. If the tax on interest income is 50 per cent, the euro will amount to 1.63 euro. Capital income tax has a significant influence on how much money you will have in ten years and how willing you will be to exchange today's apples for the oranges of the future. The differences will increase over time due to interest paid on interest. With a 10 per cent interest rate, one euro will be 17.45 euro in 30 years. If the tax on interest income is 50 per cent, the euro will amount to 4.32 euro¹⁵.

Since it does not make sense to let the tax system affect relative prices, it cannot make sense to use a device that causes distortion that will only worsen over time. This is the reason why consumption tax is preferred over income tax.

By making certain changes to the current system of taxation it can be altered to resemble a system based on the taxation of consumption. In practice, the change would be to abolish taxation of capital income. Replacing income taxation with consumption taxation could, according to estimates based on economic simulations, have rather considerable effects¹⁶ in the long run. This is explained

¹³ Judd, Kenneth L. (1985): Redistributive Taxation in a Simple Perfect Foresight Model, *Journal of Public Economics* 28 (1), pp. 59–83.

¹⁴ Chamley, Christophe P. (1986): Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives, *Econometrica* 54 (3), pp. 607–622.

¹⁵ Auerbach, Alan J. & Hassett, Kevin A. (2005): *Toward Fundamental Tax Reform*, AEI Press, Washington, D.C.

¹⁶ See for example Aaron, Henry J. & Gale, William G. (Eds.) (1996): *Economic Effects of Fundamental Tax Reform*, The Brookings Institution Press, Washington, D.C.

by the fact that income taxation does not encourage accumulation of capital, which in the long run would lead to more rapid economic growth.

3.4 What do we know now?

What do we know and what should we know to be able to provide solid reasoning for a consumption-tax-oriented tax reform? If an advanced Western European industrialised country had already implemented a flat tax, we would have empirical data to compare different policy alternatives. Since this is not the case, we have to collect information from predictions based on economic models, surveys, and experiences from the former East European countries that have newly instituted a flat tax system and from tax reforms of a smaller scale carried out in the Western world.

There is broad support in the economic literature for the positive impact of replacing income tax with consumption tax. Numerous simulations by economists predict that the percentage growth effect on GDP of a transition to a flat tax system could be in the double digits.

A survey carried out in the USA in 1998, in which 69 specialists on the public sector economy were interviewed, came to a similar conclusion¹⁷.

Moreover, experiences in countries that already have a flat tax system also indicate that the system has a positive impact on the economy, although their economies vary too much from one another to warrant decisive conclusions. Their rapid economic expansion could just as well have many other causes and a flat tax seems to have been a suitable solution for former East European countries for reasons of tax administration alone. All said, it is still a probable fact that implementing a flat tax system has played a role in the high growth figures of these economies.

The positive effects of flat tax reforms are also attested to by smaller-scale reforms carried out in many countries. The corporate tax reform carried out in Finland in 1993 is a good example and proof that in certain circumstances lowering tax percentages can bring about an increase in tax revenues.

¹⁷ Fuchs, Victor R., Krueger, Alan B. & Poterba, James M. (1998): Economists' Views about Parameters, Values, and Policies: Survey Results in Labor and Public Economics, *Journal of Economic Literature*, 1387–1425.

3.5 Political realities

Is the reform politically viable? It can become so if economic growth in countries with a consumption tax system is higher than elsewhere in the long run. In the long term, economic forces may lead politicians to change their minds because they influence the opinions of voters and the success of political parties in elections.

However, it is always very difficult to implement major tax reforms. Some taxpayer groups will win, others lose, or win less. The transition from one system to another will cause diverse and serious problems. Globalisation also places constraints because different countries employ different systems. Globally operating businesses with subsidiaries in several countries want clear and simple rules to play by so that the differences in tax systems will not be abused to minimise taxes.

Something has been learned, of course, from those OECD countries that already have implemented major tax reforms. Their experiences suggest that at least the following eight conditions must be met in order to successfully carry out a fundamental reform of a tax system¹⁸:

1. Strong politicians who are capable of influencing taxpayers' opinions with bold visions of a new tax system.
2. A package deal is needed, including the advantages and disadvantages of the reform. Some will lose or win more than others, and a way must be found to convince those who lose that within a certain time frame they, too, will benefit.
3. The reform must be based on clear and simple principles that are easy to grasp.
4. The reform process must be transparent and comprehensive. To be sustainable in the long run, it must have the support of the entire political field.
5. The period of time between announcing the reform and its actual implementation must not be too long.
6. All levels of administration must welcome the reform.

¹⁸ The OECD report is based on a presentation given by Jeffrey Owens in San Francisco on 31 March 2005 entitled 'Tax Reform: An International Perspective'.

7. The tax administration must be flexible during the transition.
8. A clear information package on the reform must be made available as of the first day.

As these preconditions suggest, even though there may be strong reasons to carry out a major tax reform it still may lack chances of success.

3.6 Countries with a flat tax

As of yet, flat tax systems have been implemented only in the former planned economies of Eastern Europe. They were motivated partly by administrative reasons because the simple administration required by a flat tax system enabled them to collect at least some revenue when there was almost nothing to collect. But an even more important reason for the popularity of the flat tax, especially in new EU Member States, is that they started with a clean slate.

Estonia was the first to adopt a flat tax system in 1994. It introduced a 26 per cent tax rate only a few years after the collapse of the Soviet Union. The other two Baltic States followed suit, with Latvia introducing a 25 per cent tax rate and Lithuania a 33 per cent rate.

Russia was soon to follow and introduced a rather low flat rate of 13 per cent in 2001. Russia's implementation of a flat tax is considered especially significant bearing in mind the large scale of its economy. So far, the results have been promising. The economies of the Baltic States and Russia have developed favourably and their tax revenues have increased substantially because tax evasion is much less advantageous than it used to be.

Serbia followed suit in 2003 with a rate of 14 per cent, then Slovakia in 2004 with a rate of 19 per cent. Ukraine implemented a 13 per cent flat tax rate in 2004. Romania and Georgia implemented flat tax rates of 16 and 12 per cent, respectively, in 2005. So far, Georgia's rate is the lowest.

Estonia's experiences with the flat tax have been so positive that it has lowered the tax rate to 24 per cent to remain competitive and will lower it further by 2009 to 20 per cent. In addition, Lithuania plans to lower its rate from 33 to 24 per cent¹⁹.

¹⁹ Rabushka, Alvin (2005): "*A Competitive Flat Tax May Spread to Lithuania*", Hoover Institution, March 24, 2005.

The new Polish government blocked the flat tax plans of one of the parties that contested, but came in second, in the last election. Some politicians in Slovenia, the Czech Republic, Bulgaria, and Hungary have expressed interest in the flat tax.

Hong Kong has had a quasi-flat tax for decades, and China is giving the idea serious consideration.

Figure 6 European countries that have adopted or are about to adopt the flat tax model



In 2004 and 2005 there was active debate in Germany on the flat tax. The issue has also been debated in Austria, Denmark, Greece, Italy, Spain, and Finland.

The debate in the UK has been heated lately and a movement has been founded in support of the flat tax.

As the map of Europe (Figure 6) indicates, the flat tax has been especially popular in countries in Finland's proximity. The countries marked in dark grey have already adopted a flat tax and those marked in light grey are seriously considering it. Considering the mobility of production factors, the ongoing process of change is hardly insignificant.

4 A flat tax model²⁰

This chapter will introduce a new tax system that applies a rather low tax rate to a very comprehensive concept of income. Since the tax base in the system is very broad, a rate of 29 per cent would in principle generate roughly the same revenue as the current system. Wage earners pay a progressive income tax, low-income earners pay no taxes at all, and as incomes grow, the euro sum paid in taxes increases, also relative to income. In this respect the tax is fair. The new system is simple and easy to grasp. It is based on the taxation of consumption: people pay tax according to what they take out of the economy (consumption) instead of what they put into it (production).

The system is based on the following principle: incomes must be taxed once and only once as close to its source as possible. The current tax system violates this basic principle in many ways. Some income types, such as fringe benefits, are not taxed at all. In contrast, other types, such as dividends and capital gains are taxed twice.

In the new system, all income is taxed at the same rate. This is one of the basic principles of the flat tax: the equality of tax rates to all types of income. When different types of income are subject to varying tax rates or different taxpayer groups pay according to different rates, people will find ways to benefit from these differences: the basic idea being to maximise the amount of tax deductions and show income where tax rates are the lowest. The system of taxation proposed in this chapter removes the motivation for such action.

4.1 Progression, efficiency, simplicity

Removing the tax burden from the shoulders of those with the lowest incomes is one of the features of the new model. The fact that low-income wage earners pay no taxes does not mean that graduated tax rates rising to high levels are needed for those with high incomes. A large tax-exempt sum combined with a flat tax on excess income creates an automatic progression and makes a system with several different marginal tax rates unnecessary.

²⁰ The flat tax principle proposed in this chapter is based on a model originally introduced by Robert E. Hall and Alvin Rabushka on the editorial pages of the *Wall Street Journal* on 10 December 1981, followed by their first book entitled *Low Tax, Simple Tax, Flat Tax* in 1983.

While the model does tax income in a wide sense, it is based solely on taxation of consumption (see Appendix 1). There are no taxes on savings. In principle, the current system taxes savings, sometimes twice in fact. It also includes a cumbersome and confused system of tax easements for compulsory and voluntary pension contributions, and favours saving for owner-occupied housing. Different types of saving involve various incentives and their overall impact is not clear. In contrast, the model proposed here taxes all income once and does not tax income from savings (a second time).

Simplicity is one of the key features of the new system. A complex system of taxation weakens the public's confidence in taxation and prompts some to engage in unlawful activities. What is more, a complex system of taxation forces both taxpayers and the tax authorities to use (expensive) tax experts.

4.2 The same tax percentage for wages and business income

Essentially, both wage income and business income are subject to the same flat tax in the new system. In fact, the model is founded on these two elements and will only function with both elements integrated into it. When the virtues of the system, such as equal taxation of all types of income, are discussed in this report, the entire system is under consideration and not just one of its elements.

It is important to remember that the business tax proposed by this model does not just replace the current corporate tax — it covers all business activity, not just the one limited to corporations. This means that it also covers each and every type of business, including self-employed individuals.

In the new system, all income is either business income or wage income (which includes wages and pensions). The tax rate is the same for both. The basic allowance makes the system progressive. With the low 29 per cent rate, the system will generate the same amount of tax revenue as the current system.

The goal of the new system is to tax income when it is consumed. This is achieved because when businesses calculate their tax base, they can deduct their labour costs, their input costs and their investments costs from their gross revenue from sales. On the other hand, wage earners pay a tax on their wage and pension income. All this means that the tax base is the GDP less investment (see Appendix 2).

4.3 The tax bases of the new system²¹

The new tax system has two tax bases, the first of which is the business tax base. The base is calculated as follows: 1) purchases of materials, goods and services required for production of goods and services are first deducted from the gross revenue from sales. Then 2) wages paid are deducted and 3) finally, investments in machinery and production facilities are deducted. The remainder is subject to a tax of 29 per cent.

The second base is that of the wage tax. Each and every taxpayer pays 29 per cent tax on their wages and pensions on the amount in excess of a 7,000 euro basic allowance. Because of this basic allowance the model is progressive. It replaces all current deductions, including the right to deduct interest paid on home loans. The wage tax base is the total sum of all wages and pensions less the basic allowances. The reason why this tax rate and basic allowance size were chosen was to generate roughly the same amount in tax revenue with the new system as the current system generated in 2003. I will explain this in the following. See Table 2 for the tax revenues of the current system.

The estimates in Table 3 are based on national income accounts. The first row shows GDP, which is arguably the most comprehensive economic indicator of income. The second row shows all indirect taxes. The third row shows imputed rent (basically the value of houses owned and lived in by families), which

Table 2 Tax revenues in the current system in 2003, billions of euro

1	Revenue from earned-income tax	18.22
2	Revenue from corporate tax	5.81
		24.03
3	Revenue from church tax and sickness insurance contribution	1.77
4	Revenue from capital income tax	1.01
5	Total	26.81

Source: Tax statistics 2004, Finnish Tax Administration publications 353.04.

²¹ See Appendix 1.

should not be subject to tax since interest in home loans would no longer be deductible and this ‘income’ does not go through the market. The fourth row shows wages and social security contributions, which businesses deduct as expenses. The fifth row shows all investment with the exception of owner-occupied homes²². The sixth row shows the business tax base after investment and wages have also been deducted (row 1 minus rows 2-5). Row seven shows the business tax revenue which is 29 per cent of the business tax base. Total basic deductions (7,000 euro per wage earner) are shown in row 8. Row 9 shows the tax base of wage income, which is row 8 less row 4. Finally row 10 shows the wage tax revenue, which is 29 per cent of row 9.

Rows 1 and 2 of Table 2 show the current revenue from earned-income tax and corporate tax, which total 24 billion euro, whereas the flat tax revenue shown in row 11 of Table 3 is 24.3 billion euro. The flat tax model would generate the same amount or more in revenue than the current income taxes of

Table 3 Tax revenues in the flat tax system in 2004, billions of euro

1	GDP	149.7
2	Indirect taxes	20.9
3	Imputed rent	3.9
4	Wages and social insurance contributions	73.7
5	Investments (excl. owner-occupied homes)	20.2
6	Business tax base	31.0
7	Business tax revenue (29%)	9.0
8	Basic deduction for all, 7,000 EUR	21.0
9	Wage income tax base	52.7
10	Wage tax revenue (29%)	15.3
11	Total flat tax revenue	24.3
12	Revenue from church tax and sickness insurance contribution	1.8
13	Total	26.1

Source: Author’s estimates based on national income statistics.

²² Since private investment excluding owner-occupied homes was 16 billion euro in 2004, public investment was also excluded from GDP in this case.

individuals and businesses. Note that this is the case with the chosen parameters without taking into account anticipated increases to revenues arising from various dynamic effects.

The revenue from business tax is 9 billion euro, which is considerably higher than the current corporate tax revenue of 6 billion euro. The reason why business tax would raise more revenue is that it covers much more than the current corporate tax. It covers all types of businesses and enterprises, including self-employed persons and those engaged in agriculture. Moreover, the base of the business tax is broader because businesses would no longer be able to deduct loan interest. The base would be broadened further by the fact that income from fringe benefits that is currently tax exempt would be taxable under the new model. These benefits include free health-care services, exercise vouchers, parking, etc., offered by employers in lieu of wages. The fact that the calculation does not allow existing capital to be deducted is also an important reason why the business tax base is broader. In contrast, new investments would be deducted in full from the tax base in the year that they are made, but since the total annual deductions of 'old' capital amount to much more than annual new investment, the former would offset the latter.

This estimate is somewhat suspect, however, because the sudden termination of deductions of 'old' capital could in some cases cause unreasonable difficulties and would arouse strong opposition. In reality, a tax reform would probably include transitional concessions, which would alleviate the tax increase on old capital but decrease revenue. On the other hand, revenues could develop favourably in the long term in any case if the dynamic effects of the reform become sufficiently substantial. In addition, capital income in excess of current market rates would be taxable also in the long run even after the reform (see Appendix 1).

The other side of the coin is of course that the revenue from the wage tax would be lower than now: 15 billion euro instead of the current 18 billion euro. The new wage tax base includes both wages and pensions. In contrast, the current income tax covers agricultural income, non-corporate business income and income from professional partnerships which total over 4.5 billion euro, and 6.5 billion euro in capital income, half of which is dividend income and the other half capital gains of assets and rental income. Most of them would fall within the business tax base.

4.4 Wage tax

The wage tax serves only one purpose: tax all income paid by employers to employees in excess of 7,000 euro to a tax of 29 per cent. It is not a system of taxation in itself but the other half of an integrated flat tax system. It covers only wages and pensions.

Table 4 shows the very simple tax return form for wage earners. The system is progressive because it taxes only the portion in excess of the basic deduction. Wage earners need only know the sum of their wages or pensions. They can make the basic deduction from their wage or pension sum and multiply the remainder by 0.29 and compare the result to the sum withheld by their employers. The majority of Finns – those not engaged in business activities – would only fill in this form. All current tax deductions would be replaced by a single 7,000-euro basic deduction. This means that for a household with two working adults, tax-exempt wage income would be 14,000 euro.

Those Finns who are self-employed or accumulate expenses in the process of acquiring an income would also have to complete the business tax return to be able to deduct their expenses. In other words, since the wage tax only covers wages and pensions, the business tax would cover many types of activities engaged in by the self-employed.

Table 4 Wage tax form

Wage tax return 2006		
Name	Toivo Suomi	Personal Identity Code 061255-155H
Address	Laulujoutsenenukja 3, 00170 Helsinki	
Occupation	Locksmith	
1	Wages	30 000
2	Pension	-
3	Total (1+2)	30 000
4	Basic deduction	7 000
5	Taxable income * (3-4)	23 000
6	Tax (29%)	6 670
7	Tax withheld by employer	6 670
8	Tax refund (7-6)	-

* Zero if not positive.

4.5 Business tax

It is important to understand that the purpose of the business tax is not to tax business. The basic principle is that people – not businesses – pay taxes. Businesses make a profit and pay tax on it on behalf of their owners. The dividends that businesses pay to their owners from profits already taxed should not be taxable income for the owners.

The business tax base includes all other income excluding wages and pensions. The idea is to tax all income in addition to wages and pensions but only once. Under the business tax, interest paid on loans or payments made by businesses to their owners cannot be deducted. Hence, all income is taxed once and there is no need to track transfers of remaining income (dividends, interest income, capital gains) to owners for taxation purposes. This would significantly simplify the current system.

Table 5 Business tax form

Business tax return 2006

Name	Vilkku ja Valo Oy	Business ID number	2214741-4
Address	Transistoritie 12, 00960 Helsinki		
Branch of business	Electronics retail		
1 Sales income			80 000
2 Total deductible costs			50 000
2a Commodities, materials and services			10 000
2b Wages and social insurance contributions			25 000
2c Investment in machinery and real estate			15 000
3 Taxable income (1-2)			30 000
4 Business tax (29%)			8 700
5 Deferred from 2005			-
6 Interest on deferred tax (4.5%²³ of row 5)			-
7 Deferred to 2006 (row 5 + row 6)			-
8 Tax payable (row 4 – row 8, if positive)			8 700
9 Deferred to 2007 (row 8 - row 4, if positive)			-

²³ For example, corporate interest is the base rate of 2.5 per cent 1 Jan-30 Jul 2006 + 2 per cent = 4.5 per cent.

The income of lawyers, doctors and others who practise their profession in the form of a business would be subject to the business tax. The same would apply to income from rent earned from apartments and from real-estate business. Employee fringe benefits would also come under the business tax.

Businesses and other entities engaged in business would complete a tax return like the one in Table 5. Row 1 on the form is for gross revenue from sales. To generate income, a business uses a number of various inputs, on which the providing company has paid taxes. Hence, the company can deduct all costs from commodities, materials and services it needs to manufacture its products. In addition, it can deduct wages and social insurance contributions²⁴, because they fall under the wage tax, the other element in flat tax. Finally, the company can deduct all investments in machinery and real estate.

Everything that remains would be subject to a 29 per cent business tax. Many of the deductions available under the current system, including interest on loans and fringe benefits given to employees by their employers, would not exist in the flat tax system. However, these changes have not been made just to broaden the tax base but in order to tax all income once only (when the income is consumed).

Because the objective is to collect business tax as close to the source as possible, abandoning the right to deduct interest on loans is justified. It makes sense because the interest income of private individuals is not taxed either.²⁵ Similarly, it stands to reason to discontinue complex write-off schemes and replace them with an immediate and full write off at the moment of investment²⁶. This would have a positive impact on investment or capital formation. As has been stated, sudden discontinuation of the right to write off 'old' capital would cause problems that need to be resolved and would probably require transitional provisions to mitigate the impact of the tax increase.

Under the current system, many fringe benefits are deductible. Businesses can deduct the fringe benefits but employees are not taxed on the income they

²⁴ In a given year, the wage tax base includes pensions but not social insurance contributions.

²⁵ If money is borrowed to finance an investment, allowing the interest to be deducted in addition to writing off the investment amounts to a subsidy, which is more than just subtracting investment from the tax base. For this reason, one cannot permit deduction of interest in combination with a 100 per cent write-off of investment.

²⁶ In English-language literature, this approach is known as 'expensing the investment'. In other words, this is a "100 per cent first-year tax write-off."

receive. This means that with a high marginal tax rate, fringe benefits can be more attractive than wages. A neutral tax system, however, should treat wages and fringes in the same way. If this were the case, employees would rather take a given amount in wages than in the form of exercise vouchers, health-care services, parking or whatever their employer offers them without really giving them the opportunity to choose. The fact is that if fringe benefits are not taxable, then tax on other income must be higher. A low and broad tax base requires that all income is taxed equally.

Since the business tax treats all investment as expenses, start-ups would often pay a negative business tax. However, they would not be taxed at a negative rate for negative income. Since negative tax cannot be collected, business tax is deferred until the company starts making a profit, as illustrated in rows 5 to 9 in Table 5. There is no limit to the number of years taxes can be deferred.

4.6 Investment and capital gains

Because the current system allows loan interest to be deducted, it makes sense to use debt instead of equity financing. What is more, complex write-off schemes require difficult calculations and tax-authority approval. In contrast, the flat tax model again starts with a clean slate. The model excludes all the investment incentives of the current system and replaces them with a simple principle: all investment is treated as expenses for the year in which it is made. Hence, all incentives concerning capital formation have to do with investing, not partly with saving, as is the case of the current system. Thanks to the simplicity of the new system, businesses and the tax authorities would no longer need to decide what is an investment and what is an expense. The flat tax system would do away with this problem.

A tax on an income from which savings are deductible is in fact a consumption tax because consumption is the difference between income and savings. Everything taken out of the economy is consumption, whereas income is what people put into the economy. The principle of consumption tax is to tax what people take out of the economy, not what they save (see Appendix 1).

Under the current system, we pay tax on the income we make from working. Part of this we save and then pay capital tax on the income on these savings; in effect, we pay double tax on savings. The flat tax would remove this problem.

However, income from savings and investment are partly subject to business tax.

This is easily explained with an example. Suppose an individual were to invest directly into his/her own firm. Suppose further that this individual earns 1,000 euro and uses the sum to buy a piece of machinery for his/her company. Under the flat tax system, the tax on that income would be 290 euro. On the other hand, there would be a deductible sum of 290 euro on the piece of machinery. The result is that no tax is paid because the taxpayer did not consume any portion of the original 1,000 euro. The machine will later generate an income, which would be subject to the 29 per cent business tax. Had the individual preferred to consume rather than invest the money, he/she would have paid 29 per cent on the consumption and the total impact would be a 29 per cent tax on consumption.

Of course, most Finns do not have their own company and hence have no need to acquire machinery. We do, however, have a well-functioning financial market through which the savings of private persons become corporate investments. Let us suppose another person who earns 1,000 euro and pays 290 euro in wage tax buys shares in some company with the remaining 710 euro. Let us further suppose, for the sake of simplicity, that a business pays the total after-tax income generated by the 1,000-euro machine to its owner. This is a realistic assumption because the company has acquired the 1,000-euro machine for the 710 euro it received from the taxpayer plus the 290-euro tax deduction it was entitled to when it acquired the machine. The person in our example benefits from the one-time write-off of investments despite the fact that the system does not allow the deduction of expenses from share acquisitions. The market shifts the incentive from the company to the individual investor.

Capital gains on rental flats, industrial property and machinery and equipment are subject to the business tax. Purchase prices are deducted as the purchases are made and sales prices are taxed when the sales are made. All those engaged in real-estate business complete the business tax return.

Because capital gains are subject only to the business tax, there can be no double tax on them (unlike under the current system). The following example will elucidate this. Consider a share in a business. Its market value is based on profits that the company is expected to make in the future. Since the owner of the share receives a dividend after the company has paid business tax, the market capitalises the after-tax earnings. When the market expects the after-tax results to rise in the future, the share price will rise, too. And when the company

records a better result later on, it will be taxed. Under the current system, with both a tax on the company's income and a tax on capital gains (capital income tax), the appreciation of the share might be subjected to double tax.

Another way of looking at capital gains is that they are not included in GDP. With the flat tax, the tax base is the GDP less investment, which gives us consumption. Making capital gains taxable would be an exception to this principle. For the sake of simplicity, export and import activities and cross-border investment will not be discussed here.

5 The economic effects of the flat tax model

The tax model presented in this report would tend to promote economic activity. By providing an incentive to work, take entrepreneurial risks, and save, it would increase overall production and raise the standard of living in Finland.

5.1 Incentives to work

When post-tax incomes increase, people will presumably work more (see pages 18-19). In the flat tax model presented here, the disposable incomes of all wage-earner groups would increase, and consequentially everyone would probably work more. Since all work would be taxed at the same rate, people would probably do many jobs that are not being done at present because of the high tax rate for secondary income.

With respect to corporate taxation, the country in which businesses operate is significant. But taxes do not merely affect the profits earned by businesses. Businesses must also take into account the situation in which they compete for skilled employees and must compensate for the personal income taxes paid by them in different countries. By international comparison, the situation in Finland today is difficult; the effective corporate tax burden is close to the international average, but the effective tax rate for those with the best skills is the highest in the world. Figure 7 shows that the tax rate in Finland for employees earning more than 100,000 euro a year is the world's highest²⁷.

Even when the international perspective is ignored, taxation affects working and therefore total production and economic growth. However, some people may at first think that it would be difficult to alter the number of hours spent on work during a week. Does not each one of us work 37.5 hours per week, year around? The answer is no. In 2003, the average number of hours spent at

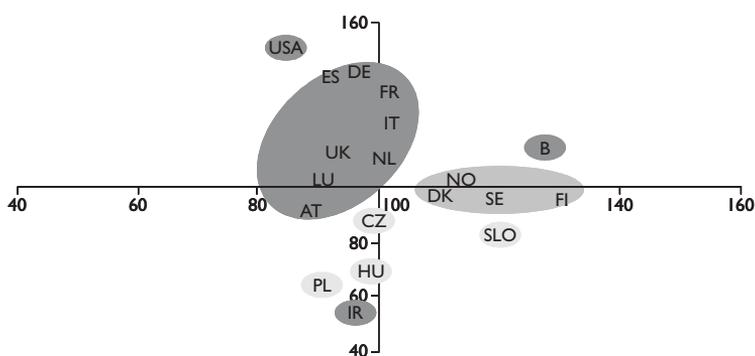
²⁷ ZEWnews, 1/2006, Centre for European Economic Research.

work by the working-age population in Finland was less than 23. Many of us could, in fact, make decisions regarding the amount of work we do.

Think, for example, about the young. Before marrying and starting a family, many young people work only part of the year. By improving their incentives, they might work for a greater part of the year. This is what the flat tax can achieve. The same applies to mothers who stay at home. If the incentives were right, it would also be possible to get them into the workforce, at least to some extent. The same is true of pensioners, who will become an extremely important resource as the population grows older. People retire too early in Finland, on average below 60 years of age. Here, too, it is a matter of incentives. There is indeed reason to assume that many people in this group would continue working for a number of years with a flat tax rate. With this in mind it is also important to recall the shape of the demographic pyramid and the coming changes in our dependency ratio.

Of course, the same arguments are also valid for all Finns working year around. They, too, might work more by doing more overtime or taking on extra jobs

Figure 7 Tax burden on businesses and people with top skills in different countries in 2005



AT = Austria, B = Belgium, CZ = Czech Republic, DE = Germany, DK = Denmark, ES = Spain, FI = Finland, FR = France, HU = Hungary, IR = Ireland, IT = Italy, LU = Luxembourg, NL = Netherlands, NO = Norway, PL = Poland, SE = Sweden, SLO = Slovakia, UK = United Kingdom, USA = United States.

The figure combines the tax burden of both businesses and people with top skills. The tax burden on businesses is illustrated on the vertical axis and the tax burden of employees earning over 100,000 euro per year on the horizontal axis. The burden in each country is compared with the average.

Source: Centre for European Economic Research, ZEW.

(since there would no longer be a separate tax deduction card for extra jobs, and they would not be taxed at a higher rate).

And of course it can also be assumed that part of the workforce now in the grey economy would work legally. Now, even the smallest businesses, employing one person, are required by the tax authorities to do almost the same amount of paperwork as large businesses that are listed on the stock exchange. Moreover, restaurants, hairdressing salons, and construction businesses²⁸ would disclose a larger proportion of their earnings to the tax authorities if tax rates were sufficiently low.

Estimates of the effects of changing over to a flat tax are difficult to make because empirical studies on the wage and tax flexibility of the labour supply often produce conflicting results (see pages 18-19). It can be said, however, that if everyone worked an additional hour per week, the effect on the GNP would be more than 1 per cent. The numbers of hours worked would increase if some people took a second job and worked more weeks a year, part-time workers worked more hours a week, and the participation rate rose. The key message is that shifting to a flat tax would have a positive effect on the supply of labour²⁹. There is reason to call attention in particular to the fact that globalisation and increasing competition tend to strengthen the sensitivity of demand for labour with respect to wages and taxes. Hence, the distorting effects of taxation also increase, and reductions in marginal taxes become even more important (see Appendix 2).

5.2 Savings and investment

One of the problems of the present system is that dividends are taxed twice. This reduces incentives and prospects for setting up new businesses in a situation in which debt financing is not available or where the sizeable risks involved prevent its use. It may be easy to obtain financing for a real-estate project, but

²⁸ Davis, Steven J. & Henrekson, Magnus (2004): Tax effects on work activity, industry mix and shadow economy size: Evidence from rich-country comparisons, *Working paper 10509*, NBER.

²⁹ In 2003, the tax rate was 44.6 per cent and 22 hours and 34 minutes were worked per week. In accordance with the estimated results of Spolander and Tarkka, a decrease of one percentage point in total taxation would increase the time spent working each week by 1.13 per cent. Verotus ja työllisyys – kansainvälistä vertailua (Taxation and employment – an international comparison), *Euro & talous*, 2005/1.

this is no longer the case for risky entrepreneurial ventures. Nevertheless, Finland in fact needs just such innovative and risky businesses. In such cases, entrepreneurs rely on risk financing, which is fortunately available nowadays. They pay the venture capitalist significant compensation, plus a 26 per cent corporate income tax on the profit earned, and a 28 per cent tax on capital income when the fruits of their labour are harvested. In other words, they first turn over a significant part of the business to their source of financing and then a large part of the income to the government. With a view to entrepreneurial risk taking, it would be more profitable to abandon double taxation of dividends.

In some cases, double taxation of dividends also encourages a business to keep profits in the company rather than to distribute them to the owners. One important feature of consumption-based models is that corporate and personal taxation become uniform.

Since the present system taxes capital income at the personal level, in addition to dividends, it also taxes interest income, rents, and proceeds from the sale of assets. In corporate taxation, interest expense can be deducted. As a result, debt financing makes more sense than other financing. In addition, taxation of capital income, as was stated earlier, increases consumption today in comparison with consumption in the future, which in turn reduces savings.

With a flat tax, income from savings and investment are not taxed. This feature is common to all tax models based on taxation of consumption; expected post-tax income to savers is equal to pre-tax return on investment. This basic feature is what distinguishes consumption taxation from income taxation.

In the present system, investment is deducted from taxable income as capital depreciates. If such depreciation is equal to the correct deduction for the value of the investment, then the gross income generated by the investment will be compared every year with the expenses incurred in generating this income and the net income will be taxed. On the other hand, if the depreciation exceeds the correct depreciation on the investment, then the net income will be taxed less. With the flat tax, such a situation would not exist, for in the model based on taxation of consumption, the entire investment would be depreciated once, at the time when it was acquired.

It should still be stressed that tax on investment return becomes especially problematic in a small, open economy in which the post-tax return requirement is determined on the international capital markets. As globalisation proceeds, the negative effects of taxation of investment return will most likely increase (see Appendix 2).

5.3 Distribution of income and fairness

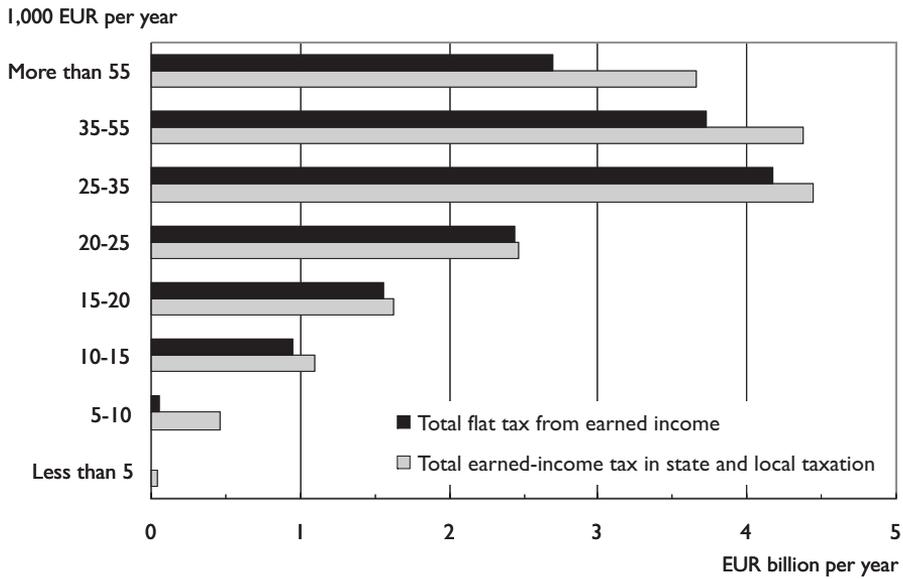
In the present situation, people with top skills as well as new, innovative entrepreneurs are subject to heavy taxation. The variety of tax incentives also means that some one ends up paying for the low tax rates of others.

The purpose of the flat tax is to improve the economic well-being of all Finns. This can well be achieved if the dynamic effects of the reform are sufficient. But even if everyone wins from a flat tax, some win more, particularly in a static analysis in which the positive effects on economic activity are not taken into account (because conclusive estimates cannot be made). In fact, the issue is largely one of how fairness is perceived. The argument for exempting those Finns whose wage incomes are below 7,000 euro a year from taxation relies on the premise that people with the lowest incomes should not be taxed at all. It is important that there is a progressive element in the model. On the other hand, lowering the marginal tax rate would of course substantially reduce taxes for those with the highest incomes (because it is just their tax rates that are so high under the present system).

Figure 8 shows how the flat tax presented in this model treats various income brackets. The breakdown by income bracket of taxes on present earned income collected by the central government and local authorities is shown in the grey area. The taxes collected on income in excess of the basic 7,000-euro deduction with a flat tax of 29 per cent are shown in the black area. As you can see, all income brackets pay less tax on earned income than under the present system, although the tax burden on those with small and large incomes decreases more than that on those in the middle.

In the uppermost income brackets, the marginal tax rates are so high that less than half of every additional euro acquired by work is left to the worker. This cannot be regarded as an incentive to work. Moreover, it must be remembered that the calculation presented does not include the dynamic effects that were sought, effects that would improve the prospects for the national economy and for each individual Finn when realised.

Figure 8 Current revenue from earned-income tax and revenue from flat tax in different income brackets in 2003



Sources: Tax statistics 2004 and author's estimates.

6 Summary

The present tax system is complex and it distorts the economic choices available to households and businesses. It leads to situations in which different incomes and individuals are taxed at different rates. The beneficiaries are those who are able to plan their activity more effectively. All those who offer intellectual capital are an example. Be they artists, musicians, architects, physicians, lawyers, scientists, or consultants, they are all in different positions relative to each other depending on whether or not they have a business. Why should this be so? It does not make sense to have to spend time thinking how much money should be taken out in wage income and how much in capital income in order to minimise taxation.

Income taxation reduces savings because it also applies to the return on savings. In addition, the present tax system affects the objects of investment and the means by which they are financed. As a result, nearly all tax reform proposals of a fundamental nature in recent years have been in the nature of consumption taxes, that is, they do not apply to the return on new investment and treat differently financed investments neutrally.

Moreover, economists have called attention to how taxation affects the labour supply. High tax rates and a steep tax progression readily lead to a situation in which the incentives for increased working are insufficient (or attempts are made to convert income from labour to income from capital). The situation would be better if tax rates were low and the tax base as wide as possible.

It is much easier to shift to the flat tax system, which is by nature a consumption tax, in theory than it is in practice. Even if everyone agreed that, when in effect, the flat tax would be simpler to administer and would have less impact on the economic choices made by individuals and businesses than the present income tax system, converting from one system to another would still be an extremely difficult challenge.

Conversion from an income-based system to a consumption-based system would increase savings by households and investment by businesses, which would promote growth in productivity and the economy over the long term. Moreover, the tax advantages of one type of investment over another in the present system would no longer exist. In the flat tax system, investment in owner-occupied housing for example would no longer receive better tax treatment than other business investment, and resources could be allocated more effectively than at present.

By expanding the tax base and by replacing the present deductions with a single basic allowance for everyone, all citizens could be treated equally. The expanded tax base would also make it possible to lower the tax percentages of wage earners. Lower tax percentages mean higher post-tax incomes, which would encourage work. The supply of labour would grow on the one hand as new workers entered the labour force from both homes and the grey economy and also because many professionals would be willing to work more. In addition, the flat tax would lower the relative price of consumption taking place in the future, and people would have an incentive to work more now and consume more later.

The shift to consumption taxation would therefore have many positive economic effects. Most simulations by economists predict that in the long term the level of production would increase from 1 to 10 per cent as a result of conversion to the new system³⁰. How positive the effects would be depends of course on how positively people and businesses react to elimination of the tax on capital income.

The flat tax would eliminate the need to work in part as a wage earner and in part as an owner, a situation that is caused by differences in the tax rates for wage income and capital income. It would mean equal treatment for different investments. In the present situation, it is more profitable for businesses to invest with borrowed capital than to use their own equity. The present system favours keeping assets in the company, at least to some extent, rather than distributing them to owners in the form of dividends. It treats limited partnerships differently from other businesses. It treats small businesses (the limit for tax-exempt dividends is 90,000 euro) differently from large ones. It treats them differently with respect to a company's equity (tax-exempt dividends of 90,000 euro can be distributed from net assets equivalent to some 1,000,000 euro). It treats unlisted businesses differently from listed ones. In the flat tax system, everyone is in the same position. As a result, resources could be allocated in an economically more effective way.

The flat tax would eliminate all tax deductions and relief for specific groups or operations. Although there may be reasonable political goals behind deductions

³⁰ See for example Auerbach, Alan J. & Hassett, Kevin A. (2005): *Toward Fundamental Tax Reform*, AEI Press, Washington D.C. or Summer, Lawrence H. (1981): Capital Taxation and Accumulation in a Life Cycle Growth Model, *American Economic Review*, 71, 4. pages 533-544.

and other forms of tax relief, it is better to abandon all of them because in any case they encourage people to participate in just those activities related to the deductions, which is not necessarily the best way to allocate resources in an economic sense. Moreover, when someone receives tax relief, others pay for it in the form of higher taxes. It would be better to give everyone a significant basic deduction.

Why, for example, is it the task of government to create a situation in which it makes more sense to live in your own house or apartment than in a rented one? If the tax deduction for loans on owned housing were eliminated, then demand for such housing would decline and resources could be allocated to rental housing and other investment. Or why are some fringe benefits provided by employers to their employees tax deductible?

Changes in savings and investment and in the GDP and resource allocation can lead to greater social equality. By minimising the impact of taxation on the economic decisions made by people and businesses, the flat tax would increase economic well-being and allocate resources to more productive ends.

Appendix 1 The flat tax base

It is essential to understand that in the final analysis, the tax base in the model under examination is private consumption and not investment (or that part of income that is saved). This is perhaps more apparent if we recall that the tax base TF for business is equal to the value added by the entire economy or the gross national product Q , from which wages W , pensions P , and investment I have been deducted, while on the other hand the tax base TH for households is the sum of wages and pensions.

$$TF = Q - W - P - I$$

$$TH = W + P$$

$$T = TF + TH = Q - I = C$$

By adding the tax bases together, the result obtained is that the tax base T for the entire national economy is the difference between GNP and investment, which is precisely consumption according to national economic accounting. (By definition, investment is equal to the production that is not consumed.)

But does the right to direct and complete depreciation on investment really mean that return on investment is not taxed? And what about the capital that is inherited from past years, is the return on this capital also tax-free? Will capital income be taxed at all in this model?

With respect to existing or 'old' capital, it must first of all be said that it will be subject to taxation, perhaps even to relatively severe taxation, if the right to depreciation on investment already made and the right to tax deductions on related loan interest were to end suddenly. This can be viewed in two ways. You could even say that increased taxation of the return on old capital would not be a big problem because it would not distort decisions to be made in the future. On the other hand, you could say that increased taxation of old capital must be avoided by means of transition rules. In this case, the accumulated tax would be less.

The issue of the taxation of new investment is more complex. It can be best explained with the simplest example possible. Let us assume that a business is carrying out an investment project, the cost of which is I while it is being made and which, in a year's time, will have generated the yield $(1+rm) I$, but nothing thereafter. In this case the tax consequences in the base of the flat tax model under examination could be depicted with the following equation (when the tax rate is indicated by λ):

Year of investment	Following year	Present value
$- tI$	$t(1 + rm)I$	$- tI + \frac{t(1 + rm)I}{1 + rd} = \frac{tI(rm - rd)}{1 + rd}$

When the tax effects of the project (direct and allocated to the following year) are discounted and their present value is calculated (using the discount rate rd), the result is that the investment project is taxed if its return rm is higher than the discount rate rd , which can be assumed to be the current risk-free market rate in the economy.

This means that the return on most investments is only partially tax free. Many incomes (monopoly profits, ‘windfall gains’) are subject to taxation. There is also reason to note that tax relief in any case applies only to new investment. The existing capital is subject to taxation, and the taxes on it will increase if the tax rate is raised (which will not happen for a marginal investment project the return on which just equals the risk-free interest).

In practice, the above means that the model presented does offer an incentive to investment, but also keeps a significant portion of the capital income generated by new investment subject to taxation.

Appendix 2 Globalisation and taxation

The tax system should be sustainable, considering the changes taking place in the economic environment and the challenges of the future. Globalisation is the principal factor. This means that the barriers to cross-border mobility with regard to goods and services, finance, business, labour, and information are being lowered. This development reflects both the national deregulation and the impact of new technology. There are grounds for thinking that globalisation will increasingly pose challenges to national tax policy, particularly in countries with high tax rates.

Let us first examine investment activity in a small open economy (Figure A1), which due to its smallness has no effect whatsoever on the return requirement of the international capital market (which is indicated by RW). The return on investment projects of the country in question is depicted by the curve I , which expresses the volume of investment that is realised as a function of R , the (expected) return on investment projects.

Let us assume that return on investment is not taxed, in which case the amount I_0 is invested in the economy. If, however, the return on investment is taxed, demand for investment will decline in accordance with the curve I' . In this case, the volume of investment will be smaller and the return on marginal investment will now correspond to a return requirement on the level I' . Taxation reduces investment, but not net return, which is determined by the return requirement of the international capital market. Alternatively, other costs (wages)

Figure A1

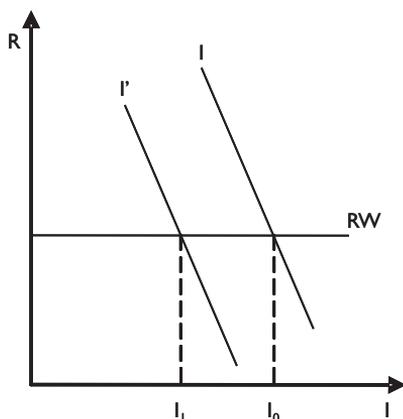
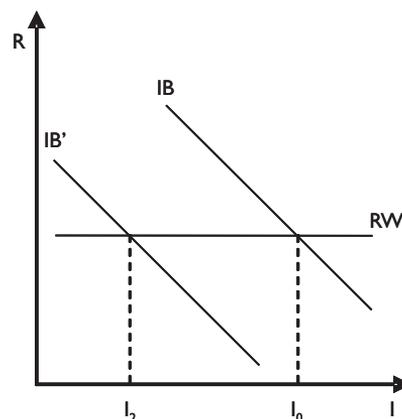


Figure A2



will have to decrease to the extent that the return requirement RW is realised at the earlier post-tax level of investment. Hence, the tax burden does not affect investors, but does have an impact on business and other domestic factors of production.

Next, let us assume (Figure A2) that we are again in the original situation I_0 . However, globalisation continues to advance, with the consequence that businesses more readily shift or outsource their operations abroad. In this case the slope of curve I , which depicts domestic willingness to invest, changes so that the sensitivity of investment to return is strengthened (curve IB). This change can be due to intensified competition on the commodity market, in which case investment dependent on production prospects will also react more readily to profitability factors.

Taxation of return on investment again means that the curve depicting willingness to invest shifts downward. But now the effect on the volume of investment (on level I_2) is much stronger than in the former case. Globalisation makes it more difficult to tax investment because changes in post-tax return lead to greater changes in the volume of investment.

It seems unreasonable to tax investment in a small, open economy; it leads either to reduced investment with a detrimental effect on economic growth or to restoration of profitability by reducing wages (in which case wage earners pay the tax on return on investment directly). The weight of this point of view will increase as globalisation advances. The advantage of the flat tax model presented in this report is that it does not tax return on new investment.

Let us now examine the labour market (Figure A3). Let us assume that the greater the employment (curve N), the higher the wage received by workers. This can be the result of the behaviour of trade unions and/or market forces. The demand of businesses for labour is in turn a declining function of gross wages (the curve L). If labour is not taxed at all, employment N_0 is in equilibrium. When wage income is taxed, the supply of labour can be depicted with the curve N_1 , in which case the gross wage is WB and the net wage WN . Taxation drives a wedge between gross and net income and thereby weakens employment.

Figure A3

