

Advantages and Disadvantages of Progressive and Flat Tax

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Abstract: Taxes are important financial instrument through which financial tools are gathered (revenues) to cover state expenditures. Taxes are closely related with the development of state administration, fact that has influenced in the expansion of the obligation of paying taxes. Taxes are a specific type of state revenue which are collect by state bodies and other legal and political bodies, from physical and legal persons in return for services which these bodies offer. Tax and taxation is called every payment required by law, in favor of state budget, based on income or property they have, consumption of goods and services they benefit. They are the main source of revenues in state budget. Proportionality and progressivity are two ways of calculating the value of taxes and taxation. The tax system in Albania has been an unexpected development with strong deviations. However, the tax authority made it possible for our country to become stronger by strengthening the country's finances. In this work are presented mainly thoughts and studies by economists of flat and progressive tax, are also presented evidence concerning the application of a model of taxation in different countries, different debates and polls that individuals and various researches have related with one or another tax.

Keywords: Taxation, Progressive tax, Flat tax, development.

Introduction

The taxation system has its beginnings particularly in the 70s -'80 in USA and UK. "Iron Lady" Margaret Thatcher and President Reagan launched an ultra-liberal revolution under the slogan "Government is not the solution, since it is the problem" that means "The problems are not solved by the government, but by the market". The main features of this radical reform, whose main goal was to release two of the world's major economies from the recession and the crisis of '70, focused on reducing to minimum the control of the government (Etat-providence), massive reduction of taxes by simplifying it in a low flat tax, mass privatization, deregulation of the economy and freeing market forces (Hsing, Yu., 1996). Under the influence of Victorian work's values, order, free initiative and "self-aid" or liberal ideas of Karl Popper, Friedrich Hayek, Milton Friedman, Arthur Laffer, etc., fiscal pressure was reduced to the maximum, public expenditure got lowered by half, economy and services were almost entirely private, the absorption of capital and attracting foreign investment turned into a cult, etc (Canto, Victor A., Douglas H. Joines, and Arthur B. Laffer., 1980). This concept and practice spread throughout the world and was served as the best form of "anti-socialist" or "anti-keynesianiste" of government management and economy. The second important moment is the "transition period - from the government to the market – that countries of Central and Eastern Europe (Evans, A. J., and P. D. Aligica, 2008), including Russia have experienced in the early 90s. States like Bulgaria, Russia, Ukraine, Serbia, Slovakia, Georgia, and Baltic countries, Hungary, Romania, Czech Republic, Albania and Macedonia gave priority to the flat tax in order to follow their idols USA or liberal England," in order to implement "structural adjustment packages of International Monetary Federation" as well as to stimulate economic growth " to build a new attractive fiscal system . The flat tax applies the same tax value to all taxpayers, without discounts or exemptions. Supporters of the flat tax system think that this system stimulates taxpayers to gain more because they will not be penalized by a higher level of taxation. Thus, they consider it fair because the system applies the same taxation regardless the income. Many of the countries that have decided to follow a system of flat tax on individuals or even

businesses, including Estonia, Lithuania and Latvia, have had economic growth at the moment that have decided to apply it. Supporters of the flat tax use various arguments in favor of it. According to them a flat tax would reduce the burden on labor and boost job offer, would avoid movement of workers by lowering taxation on people with high salaries. The taxation system would become less complicated, more transparent, and easier to be administered with low cost of compliance. It will automatically results in higher taxation revenues or at least equal to, due to the Laffer curve effect (lower taxation rates equal with more labor hours and evasion and lower fraud tax = more tax revenue), and last but not least, will attract FDI direct investment (FDI). However, contrary to what the flat tax supporters argue, research (Carone, G., Schmidt, J.H. and Nicodème, G. 2007), have found no Laffer effect or substantial effects of job offer as a result of the transition to the flat tax. A large part of the result seems to be the effect of the parallel introduction of stricter rules to combat tax fraud and to improve compliance. Russian experience in introducing the flat tax in 2001 supports the up mentioned thesis. In their article "The fall myth of Russian Flat-Tax " describe how Russia faced an enormous debt crisis in 1998 due to its very primitive system of taxation and insufficient in implementation and administration process.

According to Michael Keen, Kim Yitae, Ricardo Varsano (2006), the reasons why in our country was applied this flat fee are:

- Application of the flat tax from the new government (the case of our country) is used as a signal to move to a tax regime closer to market policies. In many cases this signal is well received.
- Major management problems, high evasion and corruption have led to the establishment of the flat tax, which constitutes a simplification by eliminating some forms of arbitration, or special treatment of certain categories. However, this does not mean that after the imposition of this tax, the tax system is more complex.
- The existence of a scalable tax structure and high tax rates which may have impacted negatively on poor management.

Administrative system in Albania, has enough problems with taxation and tax administration. Simplifying and setting a single rate lower than before will affect the increase of revenues through broadening the tax base and avoid abuses in connection with the businesses, mainly large ones to be declared as a small business.

In this perspective, it seems like the flat tax has reached his goal. There are two categories of economists' opinions about this growth (Keen, M., Y. Kim, and R. Varsano., 2008):

- First it is thought that the flat tax has increased the effectiveness of the tax system, both from an administrative standpoint and from the standpoint of tax rates.
- The second opinion is skeptical and is related with the distribution of the tax burden among individuals. It is thought that the change in distribution caused the increase in income.

Let's analyze this case by making a comparison between the previous progressive system and flat tax. According to calculations made salaries that benefit from a flat tax, therefore paying less tax than a progressive system are salaries over 140 000 All, and salaries below this limit pay more than previously. Although the government has increased salaries for this category to offset the tax increase, the absolute amount of tax they pay is greater than previously. Most salaries that are subject to the flat tax are below 140,000 All. So in other words the increase in revenue comes from taxing salaries which previously contributed less in tax revenues. So we simply shift the fiscal burden of the high level of income to average.

But to income tax there is a reduction of nearly 25 percent compared with 2006. This reduction indicates that the effect of the flat tax in terms of reducing evasion on businesses has not been very significant . Another reason could be the decrease in investment in the last two years due to the lowering of lending, increased uncertainty, reducing purchasing power, reducing remittances, etc.

2. The future of flat tax

One of the problems with our economy and the public sector are uncoordinated strategies, or in the worst case, the lack of long-term strategies. Though there is not a genuine empirical study on the effects of the flat tax, several hypotheses suggest that this tax affects positively the high levels of income by exacerbating mainly in the middle income.

Also the increasing number of countries that have applied the flat tax shows that its setting has positive effects, especially in terms of the receivership of the tax system . In relation to Albania, economists think that placement of flat taxation was positive, despite that it took political color, but this tax may be

temporary. Looking at the tax rates used by EU countries are much higher, amounting to 40 percent and policy trends in our country should be such as to go in line with our objectives to enter the European Union. Maybe switching from a flat tax rate in the next highest rate will encounter more difficulties. Another negative side that faces our country is quite in the manner of implementation. Setting the flat tax should be accompanied by more "publicity" in terms of people, to understand what will actually happen with their tax payments.

The advantages of flat tax:

- The flat tax leaves more money to the wealthy and in theory this means more money to be used for new investments and to generate economic growth and employment.
- The flat fee presumes the same income tax rates for personal and business. By this we mean that this kind of tax, applies the same defined level of income tax, whether personal or business. This means the same level of taxation for all, regardless their incomes, despite their profits. Everyone is taxed equally and pays according to the defined level.
- This kind of system gives priority to individuals and businesses with high income, which in progressive system are taxed much more. Individuals and businesses with high income do not have to pay more than other individuals and businesses. Meanwhile we all are equal before the law, why not to be equal before the "law" of taxation as well (Hall R. and Rabushka A. E., 1995).
- The Proponents of the flat tax stand that this tax defends the principle of equality before the law and taxes everyone to the same extent. Every individual or business operating in the country where this tax is applied, is equal before the law because everyone pays the amount in the manner and quantity of income based on the level of the flat tax.
- In general is acknowledged that the tax system with a single scale is easy to be managed. Flat tax system is easier to be managed because there is only one form of taxation applied and everything is taxed only once, there is no need to pay different taxes.

Why should businesses and individuals with high taxes sacrifice their investment or even their earnings to pay what other groups of population should pay?

Higher taxation of this group leads in reduction of jobs in their entrepreneurship, also leads to lack of desire for further development of these businesses and perhaps even reducing their capacity to switch their production to a lower level and consequently, the reduction of income just to pay less tax (Stephen Smith 2004).

The disadvantages of flat tax

- It eliminates the dimension of social policy through the redistribution of income that progressive taxation system offers.
- It eliminates the premises to be relieved from taxation, for less favored social groups (with the elimination of the tax exclusion clauses).
- There are no convincing evidences that this kind of tax directly stimulates productivity growth of businesses and increase employment. This tax can not directly stimulate productivity growth and increase employment because if so then why to switch to other types of taxation. It would be the solution to every country in transition.
- If there is no a minimum floor to start the application of this system, might be the risk that, in the name of total taxes to be collected, low income are taxed more heavily than higher income.
- It promotes inequality since the taxation is not progressive, so the rich get richer and the poor poorer.
- An equal treatment and equal assessment in the taxation of "profit", realized from an individual activity (wage tax) or from business activity (in the form of income tax).

A study by Decoster and Van Camp (university of Leuven) examine different scenarios in Belgium. They found that in the case of placing flat tax of 25%, without the non-taxable base and a reduction of the tax base only for professional expenses, redistribution of income will be reduced by 69%. Study by Fuest, Peichl and Schaefer for Germany (Fuest, C., Peichl, A. and Schaefer, T., 2007) on the effects of a neutral income tax in German economy, reaches the same results. They found that all scenarios – the combination of a flat tax and a non-taxable basis provide an increase in inequality and redistribution in favor of higher income. Finally there is an argument that a system of flat tax will attract Foreign Direct Investment (FDI). Taxation really is one of the determinants of investment. However, other determinants are equally or even more important.

Council of Europe (CoE) counts: the existence and quality of economic infrastructure, availability of qualified workers, perspective in different markets and countries, transportation costs, environmental standards, the level of wages, social insurance system and the general attitude of the government . We can also add legal security and the stability of governments and regulations. We conclude that the flat tax system is a nice idea, but unfortunately only that. There are better ways to achieve the claimed advantages of the flat tax without violating the principles of equity which characterize progressive taxation. If this taxation don't have a minimum wage taxation would be a huge failure, because the people with low income must pay more, which will result in the increasing level of unemployment.

3. Progressive tax

In a progressive tax system, individuals who earn more money are taxed at a higher tax level (Hyman, David M., 1990). Different from how this tax is attacked as or criticized, progressiveness idea belongs to the father of classical economics Adam Smith and his notion of "contributory capacity", claiming an equal share of the sacrifices that must make every contributor in proportion to capacity and his income. So, those who have more means and opportunity should contribute more to the state and society. Many of the countries that began to apply progressive taxation on natural persons or businesses, including Estonia, Lithuania and Latvia, have had economic growth when they changed the rules of the flat tax. Its main goal is to "create opportunities for the state or government to keep in place a social model capable of functioning, that ensures more equitable redistribution of services meeting the needs of the public for the overwhelming majority of the population, to narrow the social and territorial differences, to have the opportunity to support branches or sectors of the economy with vital importance for the country (Suits, D., 1977), to stimulate competitiveness or the health of the banking and financial sector with public money, etc. Put simply: "Tax more but offer more services and the public guarantees in education, health, transport, entertainment, etc. High taxes, indispensable to the system, create comfort to the state budget to finance these public services massively, and depending on national traditions and cultures, and with high quality .In typical countries like Sweden, Denmark, Finland, Norway, Austria or France, there is a culture on acceptance by the population of this type of taxation system, there is an efficient fiscal administration, well organized and highly competent, there is a relatively long-term stability in the level of income or profits of individuals and businesses.

Advantages of progressive tax

- Progressive tax is assessed as a more efficient means to ensure the redistribution of income in the economy. Being taxed according to the income level, then almost everyone will be offered to pay according to income level. Who earns more pays more, it means that by paying in such a way, the entire population has the same income levels, and this would decrease the gap between rich and poor.
- Progressive taxation brings more income, thanks to higher taxation on the rich. By taxing the rich more, higher level of revenue could be collected by the state. Tax 5 rich people and you will earn more than to tax 500 poor (Sarte, P., 1997).
- Supporters of progressive taxation believe that the rich should be taxed more even for the fact that they use more public services. The rich people by having higher incomes, must work to maintain the same level of income, so these people will use more roads, transport, courts etc. For this reason, the tax on these people that use more of the public goods provided by the government should be higher.
- Economies where the general welfare is higher are supported by the principles of progressive taxation. If you analyze states with the highest economic welfare almost all use progressive taxation. This is a very strong reason to think critically why these states that use progressive taxation have higher welfare than other states.
- The purpose of progressive taxation is not penalizing those that succeed, but to protect those who do not achieve and the rich pay more taxes because they benefit more from national income.

The disadvantages of progressive taxation

- Progressive tax is a camouflaged way of expropriation and confiscation, therefore a violation of the right of individual / company to enjoy complete freedom with the proceeds of a free market.
- This kind of tax maximally stimulates the evasion and fiscal "emigration" and the attempts to avoid liabilities.

- It is a tax system that is functioning as a high cost for the state and for businesses, that is very complicated in the design, documentation and its implementation.
- It's demotivating to increase production and income, while any qualitative dysfunction of fiscal administration is perceived as "abuse, punishment or fiscal inquisition."
- Progressive tax is contrary to the expected impact of comparative advantages and specialization of labor and production.
- It is very complicated and difficult to apply in cases of persons or businesses that have irregular income from one year to another (Sarte, P., 1997).
- Promotes dissolution of businesses thus negatively affecting the economic efficiency.
- Tax evasion through numerous gaps created in progressive system, cost to the state a considerable amount of income. Progressive taxation risk the corruption of public officials.
- Progressive taxes, which depend on self-declaration create incentives for forgery, perjury, bribery and corruption of the public officials.

Proposers and applicant countries of the flat tax argue that the purpose and effect of this tax are:

- Simplifying the tax system and the low cost of the collection / calculation process of the payment of fees by government and businesses.
- Increase of fiscal revenues in the budget, because simplification reduces informality and increases the number of taxpayers.
- Discourage tax evasion and stimulate the creation of new value or revenue / profit. Fiscal neutrality is favored in the sense that predictions and actions of economic agents are released from fear and suspicion of unexpected effects or unintended effect of taxes.

The main arguments of the defenders of progressive tax are:

- By taxing the rich more, creates more opportunities of consumption to the poor (keynesianist concept).
- By taxing high incomes is fought the accumulation of capital and its use for even greater profits, as the case of the recent financial crisis (neomarksist concept).
- By collecting more revenue in the budget, the state is more likely to provide on an equal basis and in a large-scale important public services such as education, health, infrastructure, transport, social support, etc.
- Having more money available, the state could easily play the role of arbitrator in social cohesion, economic policy support, etc. (etatist concept of state capitalism).
- Those who earn more should pay more (moral, ethical concept).

Conclusions

- The tax system can affect consumer behavior by encouraging them to work, to save, to education, to invest, can change their exposure to risk etc.
- Income policy has also made improvements in terms of tax rates by adjusting them with advanced tax model. Also, reforms in revenue administration have significantly influenced positively, but their level of collecting is below regional countries.
- Proportionality and progressivity are two ways of calculating the value of taxes and taxation.
- Progressive tax is assessed as a more efficient means to ensure the redistribution of income in the economy. Being taxed according to the income level, then almost everyone will be offered to pay according to income level. Who earns more pays more, it means that by paying in such a way, the entire population has the same income levels, and this would decrease the gap between rich and poor.
- Flat tax regime feeds economic growth by encouraging the production of capital and attracting foreign investments, through the increase of investment capacity in the economy.

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