The Heritage Foundation Backgrounder

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A PRO-GROWTH TAX REFORM AGENDA FOR EASTERN EUROPE

INTRODUCTION

In the wake of their successful revolutions, Eastern Europe's new democracies now face fundamental decisions that will decide their economic destinies.[1] One of the most important is the choice of new tax systems to replace those inherited from communist regimes. Under communism, East European governments supported themselves mainly by raking off revenues from state-owned industries. Today, as these countries make the transition from communist to market economies, they need new tax policies designed to promote economic growth through the expansion of private enterprise.

So far, East Europeans have been inclined to follow the example of West European states which, by and large, tax their citizens at some of the world's highest rates. These systems are designed to fund social welfare states rather than to spur economic growth. This approach has not worked particularly well in Western Europe — where it has failed to deliver on its promise of social justice and has ensured sluggish economies — and it would be disastrous in Eastern Europe.

If East European governments impose a heavy tax burden on struggling businesses and suffering consumers, the growth of these countries' nascent free market economies will slow down, perhaps leading to further social and

1 To simplify discussion, the countries of both Central and Eastern Europe, including Albania, Bulgaria, Czechoslovakia, Hungary, Poland and Romania will be referred to as Eastern Europe. Czechoslovakia, Hungary and Poland technically are part of Central Europe.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

political upheaval. This would not be in the interests of East Europeans, or of Americans, who have a strong interest in the stability of the region's new democratic governments.

In contrast to the high tax systems, there are pro-growth tax models for East Europeans to follow. Examples are the dynamic "tigers" of East Asia. These are Hong Kong, Singapore, South Korea and the Republic of China on Taiwan. They can attribute much of their economic success to low tax policies, which encourage investment, improved goods and services and hard work. Further, these countries have much higher rates of job creation and lower rates of unemployment than countries with high taxes. These tigers also have some of the most equitable income distributions in the developing world. The message is clear: low-tax economies grow faster than high-tax economies.[2]

Much Advice. In Eastern Europe, overall tax levels, tax rates, and the tax mix among business, personal income and other levies will play a major role in deciding whether these countries quickly catch up to the industrialized world, or further impoverish themselves. Right now, East Europeans are getting advice on tax reform from many quarters, including the International Monetary Fund (IMF) and other financial institutions. These institutions can have tremendous sway in Czechoslovakia, Poland and other countries since they impose certain policy requirements on recipient countries in exchange for loans. But the advice offered by international financial organizations may be wrong. The IMF, for instance, has pressured Argentina, Brazil, Chile and the Philippines to increase rather than to decrease taxes.[3]

The United States can help East Europeans resist pressures to impose burdensome high-tax policies. Washington should use its influence with the IMF and other international financial institutions to encourage them to back low-tax/high-growth policies in Eastern Europe. Mostly, however, the U.S. can offer expertise and advice in helping East Europeans to restructure their tax systems. This should include a six-point tax reform agenda for economic growth:

Point No. 1: Avoid steeply rising marginal income taxes and instead adopt a low flat tax on wages.

Point No. 2: Cut tax burdens on business and adopt a flat business tax that exempts all capital investment from taxation.

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2 Michael Marlow, "Private Sector Shrinkage and the Growth of Industrialist Economies," *Public Choice*, Vol. 44, 1986, pp. 143-154; Alan Reynolds, "The Urgency of International Tax Relief," in *Supply Side Analysis*, 1985.

3 Rowland Evans and Robert Novak, "The IMF's Poison Pill," *Washington Post*, March 23, 1990, A-23.

Point No. 3: Be wary of the Value Added Tax (VAT). Consider it only in lieu of, not in addition to, income taxes; and adopt political safeguards to ensure that the VAT is not used to fuel the growth of government as it has been in Western Europe and elsewhere.

Point No. 4: Do not use tax incentives to steer investment to preferred industries. The marketplace, not government bureaucrats, should decide which industries and technologies are best suited for investment.

Point No. 5: Do not impose high tariffs to discourage imports. Ultimately tariffs hurt consumers and producers, and slow economic growth.

Point No. 6: When possible, finance government operations and services with user fees through which most government services are paid for by those who benefit from them.

LOW TAXES: Rx FOR ECONOMIC GROWTH

Since the dawn of government, statesmen have debated the merits of tax policies geared toward economic growth and progress versus those aimed at redistributing wealth to the poor. The debate still rages, despite strong historical evidence that low taxes and minimum government regulation are the surest path to economic growth and to raise people out of poverty. Low levels of taxation and a hands-off government attitude toward the economy, after all, helped the U.S. to launch its industrial revolution in the nineteenth century and in a short time to become the most prosperous country in the world.

Heavy taxation, by contrast, is a surefire recipe for economic stagnation and collapse. High taxes were a major reason for the fall of the Roman Empire. By fifth century Rome, taxes rose to such crippling, oppressive levels that Romans had little incentive to work.[4]

Vicious Tax Cycle. High levels of taxation slow growth and development because they discourage the sort of economic activity needed to build a strong economy, including hard work, savings, investment and the production of goods and services. High taxes create a cycle devastating to economic growth.

Example: High personal income taxes discourage hard work, particularly if people are taxed at higher rates for earning more money — what is known as an increasing marginal tax rate; less work leads to a decrease in the amount of goods and services produced; lower production means businesses have less profit to invest in increased personnel and in new and more efficient plant and equipment; less efficiency ultimately translates into lower profits and

4 Charles Adams, *Flight, Fight, Fraud: The Story of Taxation* (Curacao: Euro-Dutch Publishers, 1982), p. 97.

earnings, and therefore less money deposited in banks as savings; and lower savings rates mean that less money is available for banks to invest in new businesses and other ventures. This leads to decreasing economic growth, which means lower incomes and decreasing job opportunities. University of Dallas economist Gerald Scully has found that over time, the effect of high taxes on individual incomes can be devastating.

How Different Tax Rates Would Affect Future Income[1]

Tax Rates (Adopted in 1980)	Low Tax: 19.3%	High Tax: 43.2%
Resultant Annual growth rate[2]	**2.4%**	**0.4%**
Pretax per capita income	$1,500	$1,500
Aftertax income	$1,211	$852
Effects on Income in 2000[3]		
Pretax per capita income[4]	$2,396	$1,618
Aftertax income[5]	$1,934	$919
Effects on Income in 2020		
Pretax per capita income	$3,827	$1,745
Aftertax income[6]	$3,088	$991

Source: Gerald Scully, "Tax Rates, Tax Revenues and Economic Growth," National Center for Policy Analysis, *Policy Report* No. 98.

1. The chart is based on an empirical study that examines the relationship between tax rates and economic growth in 103 countries. The projections are for a hypothetical country with a real per capita income of $1,500 – the average in 1980 of 103 countries.
2. Based on the empirical estimates produced in the study, if the hypothetical country adopts a tax rate of 19.3 percent, it will have an annual growth rate of 2.4 percent. If the country adopts a rate of 43.2 percent, the economic growth rate will be only 0.4 percent.
3. Measured in 1980 dollars.
4. Assuming all the other relevant factors remain constant over the period, by the year 2000 the low-tax policy will produce greater per capita income because the low-tax policy generates the higher rate of economic growth – 2.4 percent, as opposed to 0.4 percent for the high-tax policy. Thus under the high-tax rate, people will pay nearly $700 in taxes, and also lose an additional $778 in income because of the effect of the taxes on economic growth. Thus, the high-tax policy imposes a "growth tax" on its citizens.
5. The citizens under the high-tax policy will pay a direct tax of $700 plus the growth tax of $778, a total tax equal to $1,477/1,618 = 91 percent.
6. By the year 2020, people under the low tax rate will have three times as much after-tax income as they would have had at the higher tax rate.

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In addition to slowing economic growth, high taxes also encourage tax evasion, particularly in developing countries where governments do not have the resources or experience to track down offenders. If tax rates are too high,

people find ways to evade taxes: the rich find tax loopholes; others work in the gray economy; and businesses remain underground.

As taxes rise ever higher, economic growth grinds to a halt and tax evasion becomes rampant. Ultimately, the government that raised taxes in the first place becomes a victim of the higher taxes as its own revenues drop owing to a shrinking economy. This means fewer business and working individuals to tax and declining tax compliance.

Government officials in Eastern Europe are rightly concerned about raising enough money to balance their budgets and run the government. They worry that cutting the high tax rates will cause budget deficits and insufficient revenues to provide essential government services.

Underground Operation. These concerns are ill founded; only by cutting taxes will East European countries be able to generate steady increases in government revenues. There are two reasons for this. The first reason is that taxes on business are now so high throughout Eastern Europe that businesses are driven underground to operate in the informal, or gray, economy where they pay no taxes. This deprives the government of substantial revenues. Only by significantly cutting taxes on businesses can the governments induce private businesses to enter the formal, legal economy and pay taxes.

The second reason why lower tax rates ultimately can mean higher government revenues in Eastern Europe is that tax cuts stimulate economic growth. This means that there are more incomes and production to tax. This, after all, is what happened in America in the 1980s. The Reagan tax cuts, inspired in part by the economic studies of economists such as Arthur Laffer, ignited economic growth and increased federal revenues. (The federal deficit grew only because federal spending increases outpaced the revenue gains.) The result: the longest peacetime economic expansion in U.S. history, a 31 percent increase in the tax base, and significant growth in real tax revenues.[5]

Lower Taxes = Economic Growth: The Evidence Mounts. Substantial evidence collected over the past decade supports the proposition of Laffer, Scully and others that high taxes stifle economic growth and low taxes encourage growth. A seminal 1983 study for the World Bank by economist Keith Marsden examines the relationship between economic growth and taxation in twenty countries during the 1970s. Ten of these countries imposed high tax burdens on their citizens, and ten had low tax levels.[6] Without excep-

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5 Victor A. Canto and Arthur B. Laffer, "The Mismeasure of Man" (La Jolla: A.B. Laffer, V.A. Canto & Associates, August 10, 1990) p. 14.

6 Meaning they had high total tax revenues relative to their Gross Domestic Product (GDP).GDP is the total of all economic transactions in a country excluding trade. Gross National Product (GNP) includes trade.

Selected Industrial and Developing Countries: Comparative Performance in the 1970s

	Per Capita Income Groups $ U.S. 1979	Total Tax Revenue[1] % of GDP[2] 1970s	Real Average Annual Growth Rates of GDP % 1970-1979
Malawi (low tax)	200 - 300	11.8	6.3
Zaïre (high tax)		21.5	-0.7
Cameroon (low tax)	500 - 600	15.1	5.4
Liberia (hight tax)		21.2	1.8
Thailand (low tax)	500 - 600	11.7	7.7
Zambia (high tax)		22.7	1.5
Paraguay (low tax)	700 - 1,100	10.3	8.3
Peru (high tax)		14.4	3.1
Mauritius (low tax)	1,100 - 1,300	18.6	8.2
Jamaica (high tax)		23.8	-0.9
South Korea (low tax)	1,400 - 1,700	14.2	10.3
Chile (high tax)		22.4	1.9
Brazil (low tax)	1,700 - 2,100	17.1	8.7
Uruguay (high tax)		20.0	2.5
Singapore (low tax)	3,800 - 5,950	16.2	8.4
New Zealand (high tax)		27.5	2.4
Spain (low tax)	4,300 - 6,350	19.1	4.4
Britain (high tax)		30.4	2.1
Japan (low tax)	8,800 - 11,950	10.6[3]	5.2
Sweden (high tax)		30.9	2.0

Source: Keith Marsden, "Taxes and Growth," Finance & Development, Vol. 20 (September 1983), pp. 40-43. See also Keith Marsden, "Links Between Taxes and Economic Growth: Some Empirical Evidence," Washington, D.C.: World Bank Staff Working Paper No. 605, 1983.

1. Central government tax revenue only.
2. Gross Domestic Product (GDP) is the total of all economic transactions in a country excluding trade.
3. Including nontax revenue but excluding social security contributions.

Heritage InfoChart 1991

tion the countries with lower tax burdens had faster growth in employment, investment and productivity, and even in government services. All had higher rates of overall economic growth.[7]

Among the more interesting of Marsden's findings: investment grew at nearly 9 percent in low-tax countries, but declined by 0.8 percent in high-tax countries. Strong private sector investment is critical to economic growth because it finances factory modernization, technological breakthroughs, entrepreneurial firms and other important elements of a dynamic economy. Marsden found that high taxes imposed directly on business income were particularly destructive to investment. According to his study, every 1 percent increase in corporate income tax relative to Gross Domestic Product (GDP) led to a 2 percent decrease in the growth rate of investment.

LOWER TAXES = ECONOMIC GROWTH: THREE CASES IN POINT

Case one: West Germany's post-war economic miracle. In post-World War II West Germany, the Allied occupation regime imposed extremely high marginal income tax rates on German workers. For instance, in 1947 a German with an income of $600 was taxed at a rate of 50 percent for each extra dollar earned; by the time the worker reached an income of $15,000, the tax was at the astronomical rate of 95 percent for each additional dollar earned.[8] Because of these high rates, the West German economy sputtered and tax evasion was widespread; half of the taxes on total income were not paid.[9]

Ludwig Erhard, the economics minister, announced a program of tax cuts on June 22, 1948. Under Erhard's reforms, the 50 percent rate kicked in at $2,200 instead of $600, and the 95 percent rate was pushed up to $63,000 from $15,000. The next year Erhard nudged the threshold for the 50 percent rate to $5,000. Deeper cuts followed in 1953, 1954, 1955 and 1958. By 1959, the highest tax rate was down to 53 percent. The tax cuts improved tax compliance, broadened the tax base, increased production and spurred economic growth, thus playing a large role in the "German Economic Miracle."

Case two: Rise of the "Asian Tigers." Economic growth and prosperity among the high-growth, newly industrialized Asian tigers of the Pacific Rim – The Republic of China on Taiwan, Hong Kong, Singapore and South Korea – are the result of rapid growth in exports, minimal government regulation, and

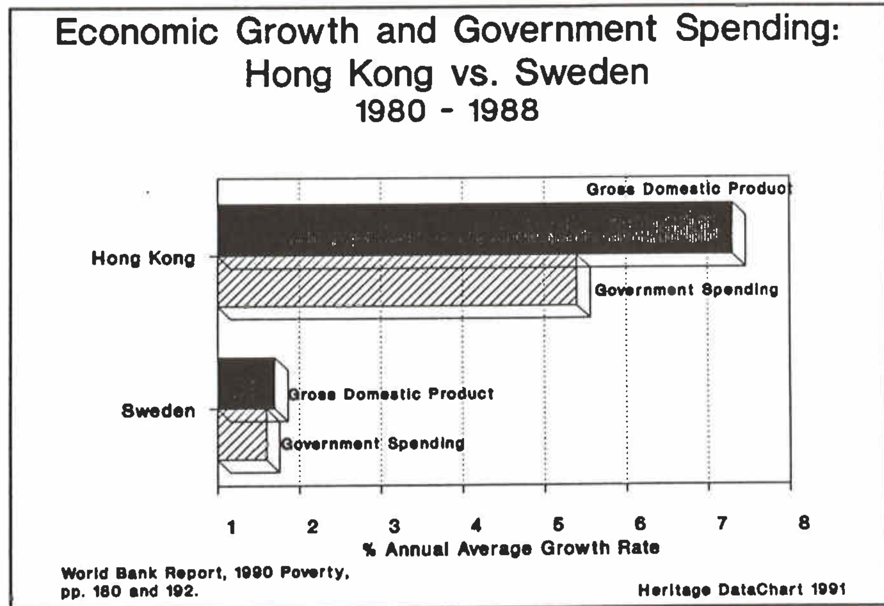
7 Because of their diversity, American states also provide a good laboratory for studying the connection between taxes and economic growth. A 1981 report from the Joint Economic Committee found that economic growth in America's states is inversely related to their tax burdens.

8 Jude Wanniski, *The Way the World Works* (New York: Simon & Schuster, 1983) p. 205.

9 Bruce R. Bartlett, *Reaganomics: Supply-Side Economics in Action* (New York: Quill, 1981) p. 191-2.

low taxes. In his study of the tigers, Hoover Institution of War, Peace, and Revolution economist Alvin Rabushka finds that all used a low-tax policy to propel themselves in a single generation from the ranks of low-income developing nations to upper-middle income advanced nations.[10]

The most successful of the tigers is Hong Kong, which has the world's lowest taxes. The maximum tax on individual income is 15 percent, while the maximum rate on business profits is 16.5 percent; compared to 31 percent and 34 percent respectively for the U.S. Hong Kong cut income tax rates eleven times from 1954 to 1974 and corporate rates six times.[11] Hong Kong has no social security taxes, and no taxes on wealth, gifts, inheritance, dividends, interest or capital gains. Largely as a result of these policies, Hong Kong is booming. In Hong Kong, average individual income increased from $180 a year in 1948 to $10,940 a year in 1989, well over a sevenfold increase in real terms. The per capita gross national product grew an average of 6.4 percent per year between 1960 and 1976; during the same period, per capita GNP grew an average of only 3.3 percent in West Germany and 2.4 percent in the U.S.[12]



The rapid economic growth generated by low taxes and free markets led to huge increases in Hong Kong government revenues. Some of these revenues were given back to Hong Kong's citizens in the form of tax cuts, and some were used to finance generous government spending on such social programs as education, housing and welfare. In fact, owing to its low tax rates and con-

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10 Alvin Rabushka, "Tax Policy and Economic Growth in Advanced Developing Nations," report prepared for the U.S. Agency for International Development, 1987, p.8.

11 Bartlett, p. 194.

12 Melvin B. Krauss, *Development Without Aid: Growth, Poverty and Government* (New York: New Press, McGraw Hill Book Company, 1983) p.72.

sequent high growth rates, Hong Kong was able to increase public expenditures faster than the welfare state of Sweden. Between 1980 and 1988, a 7.3 percent yearly growth rate allowed Hong Kong to increase government spending by 5.4 percent; during the same period in Sweden, a mediocre 1.7 percent growth rate held government spending increases to 1.6 percent.

The experience of the Asian tigers also debunks the oft-made assumption that only high taxes – particularly on the wealthy – lead to a more equitable distribution of national wealth. Taiwan and South Korea impose very low income tax burdens on individuals and businesses, relying instead on taxes on consumption, such as the Value Added Tax, and user fees for government revenues. These taxes allegedly are highly regressive. Yet Taiwan and South Korea are number one and two respectively among the world's over 100 developing nations in equitable income distribution.

Case three: Overhauling of Swedish System. The government of Sweden apparently has learned the hard way that excessively punitive tax rates suffocate an economy, and do not equitably distribute wealth. After years of dismally low growth rates, hovering around 1.8 percent annually in the 1980s, the Swedish government overhauled its tax system, effective this year. Prior to 1991, Sweden had some of the highest marginal tax rates in the world; some Swedes officially faced a total income and wealth tax of over 100 percent.[13]

The Swedish government since has slashed marginal income tax rates and wealth taxes; it now will rely primarily on indirect taxes such as taxes on consumer goods for government revenues.[14] According to Eric Asbrink, the government minister who oversees Swedish tax policy, the Reagan tax cuts were the inspiration for Sweden's change of heart.[15]

COMMUNIST TAX SYSTEMS: POISON FOR A MARKET ECONOMY

East Europeans cannot make the transition from poverty-stricken command economies to prosperous, free market economies unless they dismantle the tax systems inherited from four decades of communism and replace them with new systems conducive to economic growth. The systems of taxation employed in communist economies simply do not work in market economies. In communist countries, virtually all business enterprises are owned by the

13 Goran Grosskopf, "The Swedish Tax Reform: Rules and Effects," Bulletin for International Fiscal Documentation (International Bureau of Fiscal Documentation, Amsterdam: August/September 1990), p. 377.
14 There remain municipal income taxes ranging from 26.9 percent to 33.45 percent depending on the municipality.
15 Robert Taylor, "Sweden's tax shake-out," *The Financial Times*, January 4, 1991.

government. Taxation mostly is a matter of the government transferring money from the accounts of its own enterprises to other accounts earmarked for government expenditures. In effect, most taxes are paid by the state to the state.[16]

Taxes in communist countries can take various forms. One is the payroll tax. This often is levied on the payrolls of state enterprises and private companies in lieu of taxing workers' incomes directly. This method is meant to give the illusion that workers pay no taxes. Of course, all it really means is that taxes are taken out in the form of lower salaries. Another ploy is the profits tax. State-owned enterprises or private businesses typically pay tax rates between 40 and 85 percent on profits.

A third major revenue source is the turnover tax, which is like a sales tax except that it is levied at thousands of different rates depending on the product. In communist countries, the turnover tax really is just the difference between the price consumers pay for goods and the one retail outlets pay to wholesalers. It functions in raising revenue and in assisting the state in setting prices.

The one advantage to communist taxation is that without a history of high income taxes, it may be possible for the countries of Eastern Europe either to avoid income taxes altogether, or to impose very low, simple income taxes.

LOW GRADES ON TAX REFORM

The need for fundamental tax reform in Eastern Europe is urgent. As state enterprises are allowed to fail or to become private companies, tax revenues from the state-owned sector, the main source of revenue under communist tax systems, will tumble. Moreover, if newly privatized firms continue to be taxed at the astronomically high rates now imposed on state enterprises, they will not be able to accumulate the profits needed to invest in new plant and machinery, pay higher wages and compete on world markets.

Despite the widespread recognition that fundamental change is in order, there is no consensus on whether Eastern Europe's new tax systems will follow a low-tax/high-growth model, or a high-tax/low-growth model. Based on the reforms instituted so far, East European governments seem to be heading toward high-tax disaster.

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16 Cheryl W. Gray, "Tax Systems in the Reforming Socialist Economies of Europe," World Bank, Pre-Working Paper 501, September 1990, p. 2.

Budding entrepreneurs throughout Eastern Europe face steep taxes. Example: In Hungary, the former East bloc country with the most Western-oriented tax system, 54.2 percent of the entire national output is gobbled up in taxes.[17] The top income tax rate in Hungary is 50 percent; private businesses must pay a 40 percent profits tax, an 18 percent dividend tax on after-tax profits and a 43 percent payroll tax; and businesses and consumers pay a 25 percent Value Added Tax on nearly every item they buy.[18]

The story is much the same elsewhere in Eastern Europe. Private businesses in Poland must pay a 40 percent tax on profits, a 43 percent tax to the social insurance fund, a 20 percent tax on all wages paid, and a turnover tax ranging from 10 percent to 20 percent.[19] Such tax rates contribute to economic stagnation and increase unemployment.

Throughout Eastern Europe, payroll and social security taxes on business remain so steep that companies risk going out of business unless they find ways to avoid the taxes. Naturally, they are finding creative ways to do so. The 500 Czech workers in Miroslav Svarc's construction companies, for example, all declared themselves self-employed.[20] The result: the workers are paid double or triple the average Czech wage, the business prospers, and new homes and buildings are constructed. This would not be possible if Svarc actually paid the prohibitive taxes.

In Czechoslovakia, as in other developing countries, poor economic conditions raise the risks of entrepreneurial activity. The need for new investment and higher work effort are great. Yet these activities are discouraged by high tax rates that dampen economic activity and discourage new ventures.

The VAT Trap. The Value Added Tax (VAT) figures prominently in the tax reform plans of Eastern Europe. The VAT is similar to a sales tax, except that it is levied not only on consumers at the point of sale, but on producers at various stages in the production process. Hungary already has a VAT; Bulgaria, Czechoslovakia and Poland plan soon to convert their "turnover" taxes to standard West European-style VATs.

Since it first was adopted by France in the early 1950s, the VAT has spread to more than half the world. The VAT is popular because it raises enormous revenues while remaining relatively invisible to the consumer. He is unaware of it because largely it is paid indirectly as higher prices for products, instead of being levied directly like an income tax or sales tax. These virtues of the

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17 Government Finance Statistics Yearbook, International Monetary Fund, Washington, D.C., Volume XIII, 1989, p. 104. This is one of the highest tax burdens in the world.

18 The profits tax on Hungarian-owned businesses was cut to 20 percent in January 1991.

19 U.S. Chamber of Commerce, International Division.

20 "Reawakening: A Market Economy Takes Root in Eastern Europe," *Business Week*, April 15, p. 50.

VAT also constitute its dangers. VAT's relative invisibility and efficiency give politicians a way to increase taxes without the political backlash that inevitably comes with an increase in income tax rates.[21]

Bad Reform Advice. East Europeans are getting tax reform advice from several quarters, including the International Monetary Fund (IMF) and the World Bank. But they may be getting bad advice. Often the IMF, for example, pressures developing countries to increase taxes. In the winter of 1990, for instance, Argentine President Carlos Saul Menem wanted to cut the VAT rate to spur economic growth. The IMF opposed this tax cut and instead urged Menem to raise the VAT rate by 2 percentage points. Throughout much of 1990, the IMF pressured the Philippine government to institute a tax on luxury items. When the Philippine Congress balked at the unpopular tax, the IMF pressed for a 9 percent supplemental levy on imports, which was adopted by the Philippine government in January 1991. Such anti-growth policy prescriptions if forced on Eastern Europe, would doom the region's economies to economic stagnation. Eastern Europe needs better advice.

A PRO-GROWTH TAX REFORM AGENDA FOR EASTERN EUROPE

If East Europeans are to jump start their moribund economies, they need a major overhaul of their tax systems. Old communist tax systems should be dismantled. An aggressive, pro-growth tax agenda is needed to eliminate excessive taxes on business, simplify tax codes and minimize government interference with the workings of Eastern Europe's nascent free markets.

There will be opposition to this program. The foremost impediment is likely to be a strong redistributionist impulse left over from decades of communism. There will be enormous pressure on legislators to adopt heavily progressive income taxes, wealth taxes and high corporate income taxes.

These pressures must be resisted and the arguments strongly rebutted. Many governments worldwide have gone the high-tax route, often trying to soak the rich in the hope of helping the poor. They have succeeded only in keeping everyone poor. Economic growth is the best way for East European countries to raise themselves out of poverty. The tax systems of Eastern Europe should be structured to promote growth.

America can help, mostly by offering expertise and advice. America also can use its influence with the IMF and World Bank to prevent these institutions from luring Eastern Europe down the high-tax path. George Bush should offer as an alternative America's own Six Point Pro-Growth Tax Reform agenda for Eastern Europe. The agenda:

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21 John Blundell, "Britain's Nightmare Value Added Tax," The Heritage Foundation *International Briefing*, No.16, June 13, 1988, p. 11.

Point No. 1: Avoid steeply rising so-called "progressive" income taxes; impose a low flat-rate personal income tax.

Income taxes are the most anti-growth of all taxes. They reduce savings, cut the incentive to work, and thereby lower economic output and growth. If possible, income taxes should be avoided altogether and government revenues should be financed by such other means as user fees for government services and taxes on consumption. The development of tax systems without, or with very low, income taxes on individuals may be politically feasible in Eastern Europe, since income taxes were not a major component of the communist tax systems these countries are trying to replace. Rising marginal tax rates, which tax higher earnings at progressively higher rates, are the most damaging of all income taxes.

There is an alternative to rising, marginal tax rates on individuals: a low flat income tax. It could be levied at a rate of 15 percent or under. Only wages and salaries would be taxed. To minimize the tax's impact on economic growth, no taxes would be paid on any personal income earned as interest from savings or capital gains from investments. There would be no exceptions or deductions.[22] A flat tax has numerous advantages over rising marginal taxes. Among them:

◆ **Simplicity.**

Progressive income taxes tend to be complicated, typically including many deductions, exemptions and depreciations. The governments of Eastern Europe have neither the money, the qualified accountants or the administrative structure to process millions of complicated individual income tax returns.[23] As a result, most income taxes will go uncollected.[24] The flat tax avoids these problems. Employers would withhold the flat tax from the worker's income; each individual would fill out only a few lines on a postcard-size form once a year confirming the amount of withholding. Taxpayers could claim personal exemptions for themselves and their dependents.

◆ **Higher incentive to work.**

Increasing marginal tax rates discourage people from earning that extra dollar since they know that less of it will be theirs and more will belong to the government. A flat tax does not penalize added income, and therefore en-

22 The "flat tax" on individuals and businesses was first proposed by Henry George, and in this century by Milton Friedman. A version of the flat tax was popularized in 1982 by American economists Alvin Rabushka and Robert Hall, and a variation of the tax is now often referred to as the Simplified Alternative Tax (SAT).
23 Charles E. McClure, "A Consumption-based Direct Tax for Countries in Transition from Socialism," paper prepared for the World Bank Socialist Economies Working Group, December 1990, pp. 8-10.
24 Janos Kornai, *The Road to a Free Economy: Shifting from a Socialist System: The Example of Hungary* (W.W. Norton and Company, 1990) p. 119.

courages work. More work ultimately means more and improved goods and services.

- **Increased savings and investment.**

The emerging market economies in Eastern Europe cannot afford to punish people for making the economy stronger by saving and investing. By exempting saving from taxation, the flat tax on income will encourage investment and stimulate economic growth. It also will keep capital in Eastern Europe, to be invested at home, instead of flowing to other parts of the world where it might be taxed at lower rates.

- **No "bracket creep."**

In inflationary environments – temporarily unavoidable in post-communist countries because prices, controlled for decades, must rise to their market levels – progressive tax rates cause a phenomenon termed "bracket creep." Bracket creep occurs when people are forced into higher tax brackets owing to inflation, rather than to income increases. Bracket creep was a major cause of America's "stagflation" in the 1970s, when there were high levels of unemployment and high inflation. The flat-rate tax eliminates bracket creep since there only is one tax bracket.

- **Fairness.**

Flat taxes strictly limit the tax burden on poor families. By taxing everyone at the same rate, the rich still pay more because their incomes are higher. Further, wealthier individuals may in some cases pay a higher percentage of their incomes to taxes once personal and family allowances are considered. Example: A family of four with an annual income of $8,000 claims a $1,000 personal allowance for each family member; this family pays taxes on $4,000, which at a 15 percent flat rate equals $600, or 7.5 percent of total family income. A family of four with an income of $16,000, however, pays $1,800 after allowances, or 11.3 percent of family income.

Point No. 2: Cut tax burdens on business; adopt a flat business tax that exempts capital investment.

Without exception, East European countries impose very high tax burdens on private businesses. Examples: Czechoslovakia has a 55 percent tax rate on profits; private businesses in Hungary are forced to pay social security taxes at five times the rate of state-owned enterprises. These taxes – higher than in America, Western Europe or among the Asian tigers – put East European countries at a strong competitive disadvantage. Business taxes in Eastern Europe must be lower than those in the West if technologically backward and inefficient East European businesses are to compete with the West.

Most business expansion and job creation takes place in small- and medium-sized companies. High business taxes rob these firms especially of the capacity to expand. Reason: Most smaller businesses finance expansion through their own savings and by reinvesting their profits. High taxes on

savings and profits mean businesses can hire fewer workers, purchase fewer raw materials and tools, and thus produce fewer goods and services.

No Double Taxation. East European countries should replace the corporate profits tax with a single, low, flat business tax. Optimally it should be the same rate as the personal income tax – around 15 percent; otherwise individuals simply will try to find ways to have taxable income counted under whichever rate is lower. Nothing taxed as personal income should also be taxed as business income and vice versa. Example: Corporate dividends paid to shareholders should be taxed only once as business income for the corporation issuing the dividends, rather than being taxed twice – once as business income and again as personal income. To keep things simple, there should be no deductions for dividends, interest payments, depreciation allowances, fringe benefits or for state and local taxes.

There should be but one exception to the flat business tax. Any money invested back into a business for plant, equipment, land or other investments should be deducted from the businesses' gross revenues for tax purposes. A lack of investment capital is a key problem facing East European businesses today; investment capital is critical to the creation of new enterprises and to modernizing and expanding existing businesses. A total exemption for business income invested back into a company, known as "full expensing," would free needed capital for investment. Due to high start-up costs for new businesses "full expensing" should mean that many entrepreneurs will pay no taxes in the first year or two of operation.

By treating all business investment as fully deductible business expenses, instead of discouraging investment by taxing it, East European governments can expand entrepreneurial activity, tax compliance and productivity.

Point No. 3: Be wary of the Value Added Tax.

Most East European countries are planning to adopt the VAT in part because they wish eventually to join the European Community (EC), and the VAT is an important part of the EC's harmonized tax system. East Europeans should approach the VAT gingerly. The VAT should be considered only in lieu of an income tax on individuals and corporations, not in addition to these taxes. As Hungary's experience already shows, the imposition of a VAT on top of new income taxes imposes a tremendous tax burden on a country's citizens. The result is predictable: economic growth is lowered and tax evasion increases.

Political safeguards, meanwhile, are needed to ensure that the VAT does not become an ever expanding government money machine. One safeguard would be to require a two-thirds majority of parliament to approve any VAT rate increase. Or, governments could require any increases in the VAT rate to be approved by public referendum.

To reduce the VAT's administrative burdens, the same rate should be levied on all goods. In Western Europe different VAT rates apply to different products. This can create bookkeeping nightmares for small businesses. A uniform VAT rate applied to all items would eliminate these problems.

Point No. 4: Avoid investment incentives for preferred industries.

In the old days, East European central planners would pick industry winners and losers by explicitly directing the flow of investment. In Western economies, however, the method is subtle. Bureaucrats pick industry winners and losers by granting tax incentives for investment in preferred industries, often high-tech or other enterprises identified as "strategic" by the government. Example: The tax holidays that temporarily exempt businesses in selected industries from paying taxes. Hungary's tax system is already rife with many tax holidays and other exemptions for favored industries. Selective tax incentives to preferred industries distort market forces by artificially directing resources to uses which may be unproductive. For example, if a poor country makes taxes for the semiconductor industry much lower than for textiles, capital will be redirected from textiles to semiconductor manufacturing. But developing countries generally compete better in such labor intensive industries as textiles than in high tech industries. Thus, in this case, less investment in textiles results in high unemployment in the economy because job loss in textiles is not offset by job creation in semiconductors. In the end, the country becomes less competitive, and hence poorer.

Point No. 5: Do not impose high tariffs to discourage imports.

The eternal rationale of protectionists is that high tariffs protect local industries and jobs from foreign competition. In fact, tariffs are very destructive to local economies. High tariffs hurt consumers because they have to pay more for foreign goods, which are taxed at a higher rate. They also pay more for domestic goods because competition to local industries from foreign producers is reduced, allowing the local industries to charge higher prices and become sluggish and inefficient. Domestic businesses, too, are hurt by high tariffs; they are forced to pay higher prices for imported supplies and raw materials to produce goods. This, in turn, makes them less competitive on international markets, decreasing exports.

The domestic economy as a whole is hurt by protection because capital and labor are diverted away from their most efficient uses, and move instead toward the production of goods needed to replace lost imports. This process, known as "import substitution," damages local economies because it drains resources from the industries and services in which a country is most competitive. Result: Prices go up; locally produced goods become less competitive on international markets; unemployment increases; and economic growth suffers.

Protectionist measures designed to keep out foreign goods ultimately keep out investment, too, since declining growth rates induced by protectionism mean decreased opportunities for profitable investments from abroad. Im-

port quotas and other non-tariff trade barriers should be eliminated; tariffs should be eliminated, or at least kept at the lowest possible levels.

Point No. 6: Where possible, finance government operations with user fees.

User fees can finance a wide range of government operations. A common user fee in America and Western Europe is the toll charged to motorists for the use of some highways. People are not forced to pay for roads they may never use. Fees also can be charged for the use of libraries and public parks, for garbage collection, or to land on airport runways. By increasing the use of user fees in lieu of taxes, countries can increase the probability that only those government projects and services that are economically justified will be undertaken. Reason: If there are not enough users to finance the operating costs of the government service, then the operation will not be provided.

CONCLUSION

After years in the economic shackles of communism, Eastern Europe is struggling to free itself from state control and to build strong, free market economies. Eastern Europe has tremendous economic potential. Its greatest asset is a highly educated, skilled and energetic population; but for decades this tremendous human resource was locked up under tight state control. With these controls lifted, East Europeans can in time raise themselves to the economic levels of the West.

Creating Wealth. The success of this effort in part will depend on whether old, communist tax systems are redesigned in a way that spurs economic growth. For this, East European countries should tax individuals and corporations at very low rates, leaving them with more time and money to devote to creating wealth and raising themselves out of poverty. Time and again around the world – from Hong Kong to America – experience demonstrates that lower taxes equal economic growth. Eastern Europe would do well to heed the message.

Predictably, there will be opposition to this simple and obvious path to economic development. Politicians with a socialist hangover will argue that the tax system should be used to raise revenues for huge government programs and to redistribute income from the rich to the poor. Yet the experience of the Asian tigers – the Republic of China on Taiwan, Hong Kong, Singapore, and South Korea – shows that the fastest way out of poverty is not via government programs, but by allowing people to use market opportunities to start new businesses, earn money and enrich themselves.

Poisonous Taxes. High, rising marginal income taxes on working men and women poison a growing economy. Income taxes, particularly steeply rising marginal rates, should be avoided. If an income tax must be adopted, it should be a single, flat tax on wages and salaries at a rate of 15 percent or below. Further, dynamic growth of the private sector should be encouraged by sharply cutting the tax burden on business and replacing the corporate in-

come tax with a low flat business tax without loopholes. The single exception would be a total deduction for all revenues reinvested in the business. Governments, moreover, should get out of the business of picking winners and losers in the economy by granting tax holidays and other tax breaks for designated industries. Four decades of central planning were enough; the bureaucrats had their chance and failed. Now it is time to give the free market a chance.

East Europeans should be wary of the Value Added Tax. If adopted, it should be imposed only instead of income taxes on individuals and businesses, not in addition to these taxes. The VAT should be simple, applied to all goods equally; clear political limits should be placed on its expansion. Imports should not be discouraged by employing quotas or high tariffs. Finally, whenever possible, government services and operations should be financed by charging users directly.

Tax reform is not a panacea for all the ills brought on by the decades of communism. But combined with other essential free market reforms as currency convertibility, freeing prices from state control, privatizing state-owned enterprises, liberating entrepreneurs from stifling regulation and ending government subsidies to state enterprises, a pro-growth tax agenda can help Eastern Europe move toward prosperity and political stability. This serves the interests not only of East Europeans, but of Americans as well.

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