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Taxes

Flat-Tax Wave Ebbs in Eastern Europe

A wave of flat-tax legislation swept across Central and Eastern Europe after the fall of communism, as more than a dozen countries across the region adopted single income-tax rates —to the delight of free marketers who have long championed flat taxes as an economic stimulant.

Now, the wave is receding. Last year, even as Republican presidential candidates Newt Gingrich and Rick Perry were stumping for flat-tax schemes in the U.S., the Czech Republic and Slovakia repealed theirs, replacing them with progressive tax schemes in which richer taxpayers pay higher rates.

This week, Bulgaria's pro-flat tax ruling party won a narrow election victory that could force it into a coalition government with opponents of the country's across-the-board 10 percent individual and corporate rate. The former Bulgarian finance minister who helped implement the tax in 2008 now says it was a mistake.

STORY: Krugmenistan vs. Estonia

The lesson: Flat taxes seem to work pretty well when an economy is growing—but not so well when it is stagnant or shrinking. Across Central and Eastern Europe, "every country is in need of more revenue because of debt and public deficits," says Andreas Peichl, a senior research associate at the IZA think tank in Bonn, Germany. "There is a feeling that the crisis has affected poorer people more than the rich and that the rich should contribute more. But that is not easy to do if you only have one tax rate."

The region's embrace of flat taxes was driven by politics as much as by economics. Many countries trumpeted their flat-tax regimes as a symbol of their transition to a market economy and their openness to investment. U.S. think tanks such as the libertarian Cato Institute and the Hoover Institution responded enthusiastically. But sending that signal is less important now for countries such as Slovakia, which has attracted major investment from Western Europe.

Moreover, it's not clear whether flat taxes have significantly helped the economies where they were adopted. Slovakia enjoyed robust growth after enacting its 19 percent individual and corporate rate in 2004, and it withstood the global financial crisis better than most Western European nations. But the neighboring Czech Republic, which adopted a flat 15 percent individual tax rate in 2008, is mired in recession and high unemployment.

STORY: Eastern Europe's Workers Go West, Where the Jobs Are

To be sure, some countries remain firmly attached to their flat-tax systems. Estonia, which in 1994 became the first European country to introduce a flat tax, clung to a 21 percent individual and corporate rate during the depths of the global economic crisis, opting instead to raise revenues by hiking the value-added tax and slashing government spending. The economy recovered, and Estonia has run a budget surplus for the past two years. Yet some other flat-tax converts in the region, such as Ukraine and Belarus, are economic basket cases.

Voter unhappiness with budget austerity has fueled the recent flat-tax repeal efforts. Polls in Slovakia, for example show that public support for the statement "The government should reduce income differences" has risen sharply since 2008. "In every country there is a debate

about growing inequality and taxes for the rich," Peichl says. This was present before the crisis, but now it has been reinforced."

Bulgaria's flat tax is likely to survive for now because it's supported by the Gerb party, which narrowly took first place in elections last weekend. But, Bulgarian National Television news host Boyko Vassilev wrote in a column for the Transitions Online website this month, the flat tax is no longer seen as a "magical" solution. "It is just a tool, and maybe not the most important one. It cannot attract investors on its own if the rules are bad, corruption spreading, manufacturing neglected, workers' skills declining, and justice not served."