PROGRESSIVE TAX RATE
VERSUS
FLAT INCOME TAX

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Abstract: *The progressive income tax rate that the current government wants to introduce beginning with 2014 has been a highly debated topic in recent years.*
In this paper we present the evolution of tax rates over time and a comparison between the progressive tax rate and the flat income tax. Afterwards we present some pros and cons as a result of the study carried out by applying the taxes on the average wage.
Keywords: *progressive tax rate, flat income tax, finance, payroll, taxes*

1. Introduction

Taxes from the population are used because the national economy has not yet reached - although it continuously grows - a level so high that, the budget revenues made from the state-owned companies, the co-operative ones and the private ventures, can fully meet the ever increasing demands of our society.

Several contemporary economists argue that excessive taxes exert an adverse influence on the national economy because it undermines the incentive and the initiative of entrepreneurs and hinders the growth of production. High taxes are unfair because entrepreneurs lack the proper reward for abstinence to consume their profits and capital.[1]

2. The evolution of tax rates over time

The differentiated tax ideology, known under the name of "progressive tax" has received support from some big names in economics and political science, such as Adam Smith sau Karl Marx[2].In the Declaration of the Human and Citizen Rights, elaborated on 26th of August 1789 [3] we found the idea that a common contribution is essential

1 Miculescu Corina – Finanțe – Editura Eurostampa Timisoara 2012, pp 61-63.
2 Adam Smith, Avuția națiunilor: cercetare asupra naturii și cauzelor ei, Chișinău, Editura Universitas, 1992.
3 Karl Marx, Capitalul: critica economiei politice, București, Editura Politică, 1955-1960

for the maintenance of public administration and social balance. This will be reported equitably to every citizen according to individual incomes.

Later, the idea of progressive tax has appeared in the political program of the Communist Manifesto in 1848 [4] (pt. 10, paragraph 2) and materialized as one of the measures of transition to communism. In the second half of the nineteenth century it began to be applied in the U.S., later spreading to Western European countries.

The differentiated income tax is a progressive personal income tax through which the tax rates increase when the tax on the income base increase. The concept was launched with the idea that there should be a distinction between the distribution of income and expenses. The main purpose of the differentiated tax is to minimize the incidence of tax that people with low incomes or very small income supports and transferring them to people that are not affected negatively the same, meaning people with above average incomes.

The flat income tax was implemented for the first time in Estonia (1991), followed by Latvia (1994), Lithuania (1994), Russia (2001), Serbia (2003), Ukraine (2003), Slovakia (2003), Georgia (2004) and Romania (2005). The flat tax involves replacing complex set of different types of taxation in relation to income, with a system under which the state will declare a single rate of taxation on all income above a threshold previously set. Thus the global income is taxed only once.

As you can see from the above information, although the flat income tax is not a universal cure to the economic weaknesses of a state, a number of European countries, including several EU member states have introduced the regime "one fee for all types of income / profit". Many of these countries are however faced with substantial budget deficits, and some of them must align with the economic status requirements of the "euro zone".

However, attention is drawn to the importance of the competitiveness of a state which is influenced by other factors beside the flat income tax. Although a lower rate of taxation leads to streamline of cash flow and increases the willingness of citizens to pay taxes, lower taxes will inevitably lead to the decline of revenues on the state budget.

Moreover, there are experts, including German Chancellor Gerhard Schoder and Swedish Prime Minister Goran Persson, who said that the transition economies of Eastern Europe countries, can afford to reduce taxes, not due to the increased revenues on the state budget, but because of the grants obtained from the EU, an argument which was disputed by the criticized countries. Meanwhile, Germany, Italy,

4 „Karl Marx și Friedrich Engels, Manifestul Partidului Comunist"

Austria, Finland, Denmark and Greece have decided to cut taxes to stimulate investment and consumption growth.

In Romania, in the years 1940-1944, the tax rate of wages was a progressive tax rate. For an example for an income of up to 4000 lei, the tax rate was 4%. For the revenues that exceeded 4000 lei a tax rate of 8% was applied. In the early years of the communist dictatorship, until 1977, a progressive tax rate that went up to 16%, depending on the income of each citizen, was applied. From July 1st, 1977, the progressive tax rate was changed in the sense that the individual wage taxation was waived and the wages were taxed with proportional tax rates differentiated from 14.5% to 17.5% depending on the industry and economic sector. After the revolution in 1989, the tax rates have reached a level of 45% of the income. Starting with the governance in the 2000-2004 periods, a differentiated tax is implemented in Romania, 5 taxable income thresholds: 18%, 23%, 28%, 34% and 40% and low incomes are not taxed. Since 2005 all personal incomes were taxed with 16% through the flat income tax system, this tax being continued until today by the next governments. Later, in 2010, with the current economic crisis, a recovery plan based on the introduction of progressive taxation on the Romanian tax system started being discussed.

3. Comparative study

The Romanian government wants to give up, in 2014, the flat income tax of 16% in favor of the progressive income tax, which will have three stages, 8, 12 and 16%, according to the fiscal strategy for the period 2014-2016. According to the budget data, more than two thirds of the population currently realizes monthly incomes between 850 and 2,000 lei. The next place as share is taken by those who earn between 2,000 and 4,000 lei per month. A lot of people earn less than 850 lei (5.5% of total). Only 6% of the population obtains incomes over 4000 lei and only 1% exceed the amount of 8,000 lei per month.

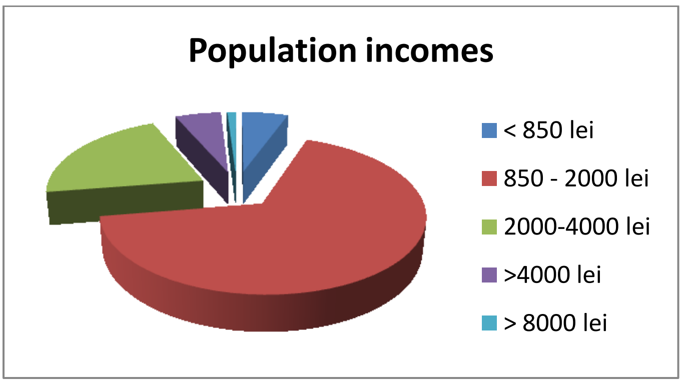
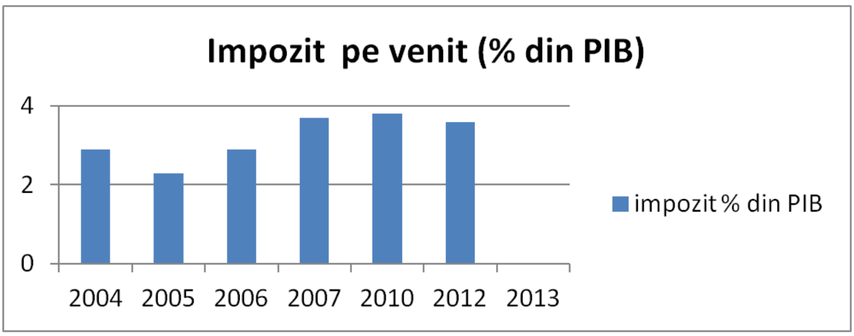


Fig. 1. Share of population incomes in 2013

In **terms of amounts to be received from the state budget**, we can say that depending on how radical will the reduction of tax income be (for example an average salary to be taxed 12% instead of 16%) – the state may lose annually between 170 and 400 million euro approximately 700 -1.7 billion lei. When in Romania were progressive income tax rates, the income stages for which the highest tax rates were applied were much higher than the average income. Thus, in 2000-2004, in Romania the differentiated taxation was implemented with 5 taxable income thresholds: 18%, 23%, 28%, 34% and 40%.

For example, in 2004, for a monthly income of 13 million lei, a tax rate of 3.4 million lei was applied (about 26%), plus 40% to what exceeded this amount. 13 million lei represented twice the net average wage. If the Government will implement the same strategy, it is possible that the taxation of 16% to be realized on an income of more than 3000 lei, which is almost twice the average wage and thus the budget loss will be much higher.

Although the minimum tax stage up to the end of 2004 was higher than the current flat income tax of 16%, not to mention other tax allowances, the taxes on the income brought in less money to the budget than the flat income tax. Specifically, in 2004, the last year of the progressive tax, the taxes on income have made the budget a sum equivalent to 2.9% of GDP. In the following year, the first year of flat income tax application, the collection was reduced to 2.3% of GDP, as in 2006, to revert back to 2.9% of GDP. In the following year, the collection has grown considerably, reaching a level of 3.7% of GDP. Moreover, in the crisis year of 2009, when the national economy was strongly affected by bankruptcies and unemployment, the income tax brought to the state treasury 3.8% of GDP.



Source: Money.ro Published: 13 feb 2014

So, at a first glance **the state does not win**. The danger is that when you have a progressive tax system, any "creative" government can change a tax. To move it up or down on the salary scale. In a short term,

the risk of a fiscal instability, that Romania really has no shortage, **greatly increases**.

From the perspective of sums received by employees, there will be a slight increase at the population whose earnings are below average. By this measure the government expects to increase the consumption to stimulate an economic recovery and the end of the economic crisis, meanwhile the exports will decrease, the reduction of tax evasion seems impossible and attracting EU funds remains at the stage of a desiderate. As an example, let's assume that a reduced rate of 12% will be put on the average wage. For an average gross salary of 2300 lei, the company currently pays taxes and contributions to the state of 1311 lei. For the same amount, but for a microenterprise the state is transferred only 437 lei after paying the income tax and tax on dividends. If the amounts that will be collected would be higher, it's hard to believe that at the current social contributions level someone will take this step and give up the comforts of a microenterprise in the detriment of contributions of employer / employee.

Table 1. Comparative study of how to determine the net gain.

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Salariu BRUT	0,50%	10,50%	5,50%	250	IMPOZIT	Salariu NET	20,80%	5,20%	0,50%	0,85%	0,25%	0,16%	TOTAL CONTRIB		
Cota de impozit pe salar de 16%															
2.300	12	242	127	88	293	**1.627**	478	120	12	20	6	**4**	**638**	**1.311**	**2.938 lei**
Cota de impozit pe salar de 12%															
2.300	12	242	127	88	220	**1.701**	478	120	12	20	6	**4**	**638**	**1.238**	**2.938 lei**

With more money in their pocket, Romanian people are expected to spend more, so that the state could collect more tax money. Meanwhile, for Romanian people spending mainly means food consumption, a reduced VAT for them would mean, lower prices, thus potentially higher sales.

The introduction of a **progressive tax involves a more complicated accounting calculation**. Thus, for the portion of income that falls within a certain limit a specific tax rate is applied and for the amount exceeding this level, but still does not reach the next level of taxation, a higher tax rate is applied.

Also there are a number of additional staff costs arising from which the state must assure the proper implementation and the enforcement of the tax rate and other losses, difficult to foresee which should be taken into account. They are not an economic problem as long as the government does not want to recover these losses.

In conclusion we made several arguments for and against progressive tax rate:

Arguments for

- The differentiated tax is a solution for governments with budgetary problems, because, by using it, the number of taxes that can be collected is more effective and the level of social discontent will decrease.
- The differentiated tax leads to lowering the financial inequalities, which implies more social benefits. In this regard, Richard Wilkinson argues that the society, by becoming unequal, lower and middle class people are exposed to poor lifestyle: they are less healthy, they don't involve in the society and community life are likely to become obese and domestic violent.
- The system makes the differentiated VAT a viable alternative, lower for basic products and higher for luxury goods. Thus, people with lower incomes receive support in the purchase of consumer products for a decent living.
- At the same time, the differentiated tax allows greater support for citizens with lower pensions because the system progressively reduces the tax burden and therefore, such incomes are not so affected.

Against arguments

- The progressive tax is not justified for those who would have to pay higher taxes because they provide appropriate means of circumvention. Thus, differentiated taxation implies a different and complex financial administrative system that encourages the bureaucracy.
- The differentiated tax leads to the elimination of capital investment for consumer goods. This is because people with above average incomes are turning to equity investments, while those of the lower classes, with very high incomes, turn towards consumer goods.
- Also, a very high progressive tax may encourage an emigration phenomenon due to the misalignment to the international market demands. In this way, it may outsource certain services, for people not having to pay so many taxes and go through all the bureaucratic process.
- Some studies highlight the fact that progressive taxation does not actually lead to diminishing financial inequality
- The introduction of the progressive tax involves a more complicated accounting calculation.
- Additional costs of implementing, monitoring and collection of the progressive tax rate.

- There are also arguments for liberal or libertarian thinkers (led by James A. Dorn) who argue that differential taxation violates equality before the law

The flat income tax has the following **advantages**:
- Reduces the inequality (the same tax rate for all)
- Reduces the tax evasion
- Provides incentives to those who want to save and invest,
- Eliminates all kinds of exceptions and exemptions on fee payments
- Encouraging investment in shares (obtaining dividends), as profits are taxed only once, at the source.

Disadvantages
- It favors rich people in detriment of the poor

Finally, the progressive tax, as it is wanted to be implemented using an interval under 30-35% is inefficient both in terms of amounts received to the state budget and from the perspective of the employers, that will always be tempted to give employees' wages below these limits to avoid paying increased taxes, thereby encouraging the tax evasion. Also from the perspective of the employee this tax is an injustice. It is a kind of a punishment for a competent man, who trained for the possibility to secure a better income, and with this regime he is taxed more compared to one that did not invest in him for securing a higher salary.

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