CATO INSTITUTE

Tax & Budget BULLETIN

No. 28 • November 2005

Catching Up to Global Tax Reforms

by Chris Edwards, Director of Tax Policy, Cato Institute

President Bush's Advisory Panel on Federal Tax Reform has proposed two plans to modernize the tax system.[1] Both plans would take steps to simplify the tax code and reduce taxes on savings and investment. But the plans do not include large enough cuts to top individual or corporate tax rates.

Many countries have cut their income tax rates in recent years to attract foreign investment and promote growth. The reforms in Eastern Europe have been particularly dramatic, with many countries adopting flat-rate taxes for individuals. Countries in Europe and elsewhere have also made large cuts to corporate tax rates.

In today's competitive global economy, policymakers need to respond to foreign reforms and cut U.S. income tax rates. As a first step, they should consider versions of the Advisory Panel's plans that cut the top individual and corporate rates to at least 25 percent. If such reforms were enacted, it would help America regain its competitive edge and boost investment, wages, and growth.

Flat Tax Revolution

Nine nations in Central and Eastern Europe have enacted personal income taxes with single rates and few deductions—flat taxes. Combined with corporate tax rate cuts, the reforms have spurred economic revival in formerly moribund economies. The table shows that the United States has much higher tax rates than do the flat tax countries, and it has a much higher corporate rate than the average of the 25 European Union nations. The following countries are some of the world's tax reform leaders.[2]

Hong Kong. Hong Kong has long had one of the world's most efficient tax systems. The corporate income tax has a low 17.5 percent rate. The individual income tax has graduated rates from 2 to 20 percent and various deductions. Alternately, individuals can opt to pay a 16 percent flat tax on a broader base. Individuals are not taxed on dividends or capital gains.

Ireland. Ireland has the second-highest income per capita and the lowest overall tax burden in the EU.[3] Its economy has grown rapidly as a result of pro-market reforms including tax cuts, which have attracted large capital inflows. The corporate tax rate is just 12.5 percent.

Estonia. Prime Minister Mart Laar launched the European flat tax revolution in 1994 by instituting a 26 percent tax on individual and corporate income. Estonia is currently phasing down its rate to 20 percent. Another pro-growth change, adopted in 2000, was to exempt corporate retained earnings from tax. Estonia has become a magnet for foreign investment and has enjoyed real annual growth averaging 5.7 percent since 1995.

Top Statutory Income Tax Rates, 2005

Country	Individual	Corporate
Countries with Individual Flat Taxes		
Estonia	24.0%	24.0%
Georgia	12.0%	20.0%
Latvia	25.0%	15.0%
Lithuania	33.0%	15.0%
Romania	16.0%	16.0%
Russia	13.0%	24.0%
Serbia	14.0%	14.0%
Slovakia	19.0%	19.0%
Ukraine	13.0%	25.0%
Flat tax countries	18.8%	19.1%
Other Countries and Regions		
Czech Republic	32.0%	26.0%
Hong Kong	16.0%	17.5%
Hungary	38.0%	16.0%
Ireland	42.0%	12.5%
Poland	40.0%	19.0%
Singapore	22.0%	20.0%
Europe: 25 countries	40.6%	26.6%
United States	38.6%	39.5%

Source: Author, based on sources in endnote 2. Rates include the national and average subnational tax rate.

Lithuania. In 1994 Lithuania cut its corporate tax rate to 29 percent and its top individual rate to 33 percent. In 2002 the corporate rate was cut to 15 percent. In 2005 Lithuania passed a phased-in cut to its top individual rate to 24 percent. The tax rate on dividends is 15 percent.

Latvia. In 1995 Latvia cut its top individual tax rate to 25 percent. The corporate tax rate was reduced from 35 percent in 2001 to 15 percent in 2004. Domestic dividends are exempt from tax.

Hungary. Hungary cut its corporate tax rate to 18 percent in 1995 and reduced it further to 16 percent in 2004. Hungary has a top individual income tax rate of 38 percent, but dividends are taxed at a lower rate.

Russia. In 2001 Russia replaced its individual income tax, which had rates up to 30 percent, with a 13 percent flat tax. In 2002 it cut its corporate tax rate from 35 to 24 percent. Russia's system is not a pure flat tax, as it retains some deductions and narrow provisions. Domestic dividends are taxed at just 9 percent. Russia's tax reforms have been a big success. In recent years, the nation's economy has grown strongly, tax revenues have soared, and tax evasion has fallen.

Serbia. In 2003 Serbia enacted a flat income tax with a 14 percent rate on individuals and corporations.

Ukraine. In 2004 Ukraine replaced its individual income tax, which had a top rate of 40 percent, with a 13 percent flat tax. It also cut its corporate tax rate from 30 to 25 percent.

Slovakia. Slovakia adopted a flat rate tax of 19 percent on individuals and corporations in 2004. The top tax rates had been 38 percent and 25 percent, respectively. For individuals, the flat tax has a large basic exemption and few special preferences. Dividends are exempt from tax. Slovakia is attracting large investment inflows from Western Europe, and its economy is growing strongly.

Poland. In 2004 Poland cut its corporate tax rate from 27 to 19 percent. The top individual rate is a high 40 percent, but reforms may be on the way. One party in the new coalition government favors a low-rate flat tax, while the other favors a cut in the top rate to 32 percent.

Georgia. In 2005 Georgia adopted an individual flat tax with a 12 percent rate. The top individual rate had been 20 percent. The corporate tax rate is 20 percent.

Romania. Soon after coming into office last year, Romania's new president issued an edict to replace the nation's income tax with a 16 percent flat tax on individuals and corporations, effective for 2005. The top tax rates had been 40 and 25 percent, respectively.

Recent Developments and Outlook

The large benefits of cutting top income tax rates suggest that the trend will continue for some time. Nations are cutting rates to attract investment, reduce tax evasion, and make tax systems more fair and efficient. Here are some recent developments:

- Israel is cutting its corporate rate from 34 to 25 percent and its top individual rate from 49 to 44 percent.
- Greece is cutting its corporate rate cut from 35 to 25 percent and is considering a flat tax for individuals.
- Austria cut its corporate tax rate from 34 to 25 percent in 2005.
- Netherlands reduced its corporate tax rate from 34.5 to 31.5 percent in 2005 and is considering further cuts.
- Germany's new conservative chancellor wants to cut tax rates, but even the former leftist chancellor had planned to cut the corporate rate to boost growth.
- France is planning to cut its top individual income tax rate from 48 to 40 percent.
- Belarus is considering adopting a low-rate flat tax, like the one in neighboring Russia.
- Slovenia's leader plans to enact a flat tax after being inspired by Estonia's success.

The Bush Advisory Panel's proposals would create tax systems with three or four individual rate brackets and top individual and corporate tax rates of 30 percent or more. Those would be only minor tax rate changes compared to some of the reforms enacted abroad.

The United States is particularly lagging on corporate tax reform. Ongoing tax cuts have reduced the average corporate rate in the 25 EU countries to just 27 percent. That compares to 40 percent in the United States, based on the federal and average state rate. U.S. policymakers need to wake up to the new global tax realities and put marginal rate cuts front and center in upcoming federal tax reforms.

---

[1] President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," November 2005.

[2] Numerous sources were used for this Bulletin including European Union, "Structures of the Taxation Systems in the EU," 2004; Organization for Economic Cooperation and Development (OECD), various working papers; KPMG, "Corporate Tax Rate Survey," 2004; www.russianeconomy.org; www.freedomandprosperity.org; and news articles from *Tax Notes International* and www.tax-news.com.

[3] OECD, "OECD in Figures," 2005, p. 12. Income is GDP per capita (at purchasing power parity). See also EU, 2004, p. 165.