



FLAT TAX: MYTHS AND ALTERNATIVES

It is seriously worrying that the major proposal emanating from most corners of Europe's political right to improve the European Union's ailing competitiveness is the introduction of a flat tax regime. It constitutes the disguise of political ideology through use of populist and corporatist politics. Ultimately flat taxes, as distinct from lower taxes across the board, will accommodate two classes of people; those who earn a lot and declare a lot, and those who earn a lot and declare a little. It will lower taxes for the former and fiscally legitimise the latter. Every one else will be left hoping to enjoy from the trickle-down. The myths expounded within the flat-tax lobby are several. I would like to explode just four of them.

The first myth is the expectation that developed countries will benefit from flat taxes in the same manner as developing countries. This argument is grossly simplistic. A number of emerging economies may have been successful with flat taxes because at the outset they had very low tax compliance coupled with comparatively low provision of social services. The introduction of low and flat taxes within such economies improved compliance and brought much-needed funds into state coffers. It is always easier to grow from a lower base. What these countries enjoyed was not flat-taxes but low taxes. As these countries continue to develop their social systems the demand for more tax revenue will necessitate a re-think of their tax regimes; it is a question of time. Assuming that the same economic and fiscal paradigms can be transposed onto an economy such as Germany, or ours for that matter, is far too simplistic and simply absurd; ask Angela Merkel!

The second myth is that a flat-tax system is a positive inducement towards attracting Foreign Direct Investment (FDI). This is completely untrue. FDI is never ever influenced by its host country's tax system because foreign companies are practically always given a zero-tax status in their "adoptive" country. In Malta successive fiscal incentives have ensured that foreign firms here almost always operate tax-free. It is the price we have paid for providing much-needed employment to thousands. This same reality applies to other countries, including the EU's industrial competitors in the developing world. Foreign multinationals command so much financial and political clout that a tax-free status has become a prerequisite to marketing any foreign investment. A flat tax system will not make any material difference in securing FDI because FDI is hardly ever subject to taxation!

The third myth is that a flat-rate tax system will be simple to operate and will thus reduce compliance costs as well as bureaucracy. This reasoning could apply in a number of other countries, however nobody can really describe Malta's tax code as excessively complex. Some simplification would be nice, I admit. However what, in reality, would constitute a beneficial simplification of our direct tax system; the reduction from six tax bands to one? How more complex will it be to have three or four?

The fourth myth is that flat taxes will reduce tax evasion – wrong again. It is lower taxes and well-focused enforcement that will lower evasion, but not flat taxes. Attempting to make a

parallel argument with the lowering of personal taxation from 65% to 35% in the late eighties/early nineties is fallacious. The imposition of a marginal tax rate of 65% was outright immoral and effectively had institutionalized tax evasion, resulting in billions of liri finding their way out of Malta in the seventies and eighties, only to be repatriated (at a very advantageous 5% penalty) during the last four years. A reduction from progressive taxes with a maximum of 35% to a regressive flat 25% will not have the same proportional effect.

Flat taxes are to government revenue what golf is to tourism; a smokescreen. We should preserve the progressive nature of taxation. It is a pillar of social justice, upon which the social market economy we live in is dependent. It ensures that taxation is collected from those who can afford to pay for it. Moreover it ensures both fiscal justice and social cohesion. Flattening taxes to accommodate and legitimise evasion is defeatist political behaviour. The rich who continue declaring lower middle-class incomes can and must be weeded out. If strong compliance and enforcement are deemed ineffective, indirect taxation on luxury goods and services will do the job.

Having said this I believe that a number of changes in our tax system are overdue. Rather than simplification we need sophistication. Tax policy should not only be designed to collect revenue for the state; it should also serve primarily to allocate resources efficiently and to stimulate critical sectors of the economy. Just to take one example: a small companies' tax rate (naturally lower than 35%) was called for by the Greens before the last budget; in vain. Why are we still taxing every company in Malta at 35%? Why are our commercial banks and our SMEs facing such an indiscriminate tax regime? Another example in which our tax system is completely unsophisticated is the way it completely excludes children from the equation. A couple with no children and a couple with three children both earning say a joint income of Lm 10,000 per annum both pay the same tax – to add insult to injury neither couple is entitled to children's allowance. Is this right?

If anything, over the medium term we should be aiming for lower taxation across the board, rather than flirting with flat taxes. However this cannot be done before we weed out the ultra-abusive. It is completely unacceptable for anyone earning Lm 20,000 to get away with declaring Lm 6,000, picking up his/her children's allowance cheque in the process. In order to be in a position to lower everybody's taxes, government must ensure that everyone is submitting (at very least) a fair declaration. I do not believe that government should embark on a sharp and abrupt reduction. In the prevailing dire fiscal conditions our country faces, this may just be too risky. We should aim to lower (every taxpayer's) income taxes gradually, say by 1% per annum over a five year period. With improved compliance a top tax rate of 30% is a realistic target. Naturally this presupposes that serious cost control by government is achieved.

Flat taxes are political ideology; lower and selective taxes are strategic. Take your pick!

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