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Flat Tax, the solution?

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Abstract

This article presents a comparative study of the tax burden of the Portuguese tax system, with the application of progressive rates and proportional rates (flat tax) in determining personal income tax.

For this work we chose case study methodology, specifically comparative case study methodology, because it is understood to be the one best suited to the complexity of the subject under review.

The results demonstrate that flat tax respects the constitutional principle of progressive tax rates; Portuguese taxpayers with lower (higher) incomes pay less (more) taxes on personal income compared to the flat tax; that the existence of progressive rates does not mean Portuguese taxpayers benefit; and that the flat tax can achieve higher tax revenue than the IRS (Individual Income Tax) in force. Although adoption of the flat tax is possible, it is not believed this adoption would be feasible for political reasons.

Keywords: individual income tax; flat tax; progressive tax; proportional tax; Portuguese fiscal economy.

JEL Classification: H24

1 - Introduction

The constitutive rules of fiscal reform are incorporated in the Constitution of the Portuguese Republic (CPR). Among these standards, attention is drawn to the state's responsibility to regulate taxes in harmony with family responsibilities and to correct inequalities in the distribution of wealth and income through fiscal policy (Article 104: CPR) These objectives are reinforced with the constitutional provision, that tax on personal income aims to reduce inequalities, will be single, progressive and take needs and household income into account (Article 104: CPR).

However, the Group Report for the Study of Tax Policy - Competitiveness, Efficiency and Justice of the Tax System (Santos & Martins, 2009) recognizes that the Portuguese tax system, particularly with regard to direct taxes, including IRS, is burdened with extremely complex rules and emphasizes that a good tax system is one that has a broad tax base, not eroded by numerous exceptions, combined with moderate rates. And when referring specifically to IRS, the challenges are even greater. On the one hand, it states that it does not seem appropriate to consider IRS as a single tax, since none of the income originally submitted to final withholding tax now has to be aggregated and subject to progressive rates. Furthermore, IRS never guaranteed a minimum of existence. It also notes there has been a structural change in the original model with regard to the subjectivism paradigm of the tax, since the law decreed a guaranteed minimum rebate, regardless of origin of the total net income, which was subsequently amended with the option of full transfer of rebates from income to deductions at collection (Santos & Martins, 2009).

There is no doubt that IRS is not a single tax. Basto (2007: 25) states that "[IRS is not] a true flat tax on income, if by single tax we understand a tribute levied on total income evenly without any distinctions between people’s different types of income". Nabais (2008: 22) adopts a similar position when he says: "the current taxation of income is presented as a dual taxation, since strictly speaking, regarding personal income tax we have two completely different taxes".

Although IRS is not a single tax, it seems there is no doubt about the importance of this tax, and therefore, it should be asked how the tax burden for taxpayers can be distributed. Rosen & Gayer (2009) suggest four main proposals: 1) A lump-sum tax; 2)

proportional taxation of income; 3) proportional taxation of income with exemption for lower incomes; and 4) taxation with progressivity in rates.

The Portuguese Constitution, in Article 104, by requiring that the tax on personal income is progressive and contributes to the reduction of inequalities, eliminates the proposals of a lump sum tax and a proportional rate.
It is important to understand if the constitutional goal of IRS progressivity can be achieved with the use of progressive rates or a proportional rate, with exemption for lower incomes, i.e., progressive rates or flat tax?
This article seeks to examine the taxation of personal income in Portugal, with the application of progressive rates, as is the current IRS, compared to flat tax, that is, with the application of proportional rates.

To this end, we opted for a research strategy based on case study methodology, and within this methodology, the multiple case study or comparative case study methodology, seemed to be the one best suited to the complexity of the subject studied.

Following this introduction, the article is divided into four sections. In Section 2 we provide a framework of IRS and flat tax. Section 3 consists of the comparative study of the tax burden of the Portuguese tax system with a progressive rate and flat tax. In Section 4 we present the results and the next section discusses the results obtained. Finally, we present the findings of this study and point to avenues for future work.

2 - Progressive rates or flat tax

2.1 - Individual income tax

The preamble to the IRS Code (CIRS, 2013) states that the introduction of this tax arose from the need to adjust the direct tax regime to the provisions of the Constitution, that is, that income tax should be a single, progressive tax and take into account household needs and income.

According to the IRS Code, this tax is levied on the total annual income earned by resident taxpayers in Portugal (domestic or foreign source) and on income earned in Portugal by taxable persons who are not resident. Article 1 of the IRS Code states that tax being levied on total annual income makes it necessary to then undertake

aggregation, i.e., the sum of all proceeds from various categories, with specific deductions made for each of them, in order to obtain the tax base. Once the tax base is found, the fees provided for in Article 68 should be applied (applying, where appropriate, the marital quotient), resulting in collection. With collection obtained, when appropriate, the deductions at collection foreseen in Articles 78 and following will be made. This operation will determine the amount of tax payable or receivable.

2.2 - Flat Tax

In the last quarter of the last century, more precisely in the issue of March 25, 1981, the Wall Street Journal published an article by Alvin Rabushka called "The Attractions of a flat-rate system", establishing some principles that should be part of a proportional system (Rabushka, 1981). Later that year, on 10 December, together with Robert Hall, Alvin Rabushka published another newspaper article entitled "A Proposal to Simplify Our Tax System", which embodied what they perceived to be the simplification and reform of income tax (Hall & Rabushka, 1981). These authors propose that all income is taxed only once, and preferably as close to its source as possible. Thus, all types of income would be taxed at a single rate (in this case 19%) without deduction or exemption, where the poorest families would be exempt from paying the tax. The intention was also to simplify the entire administrative process, so that the income statement could fit in a "postcard" (Hall & Rabushka, 1981, 1983, 1985). This leads to the so-called flat tax.

The proposal is not exactly an example of a pure proportional rate. A pure proportional rate occurs when the tax payable is calculated by multiplying a fixed tax rate by the tax base (Almeida, 2000). What truly characterizes the proposal of Hall & Rabushka (1981) and differs from a pure proportional rate is the claim that taxpayers with lower incomes or the poor are exempt from tax. This exemption requires the introduction of a new zero tax. Therefore, the flat tax has two rates: 1) a zero-percent rate for incomes below or equal to the minimum subsistence level; and 2) a t rate for income that exceeds minimum subsistence. This introduces exemption in the progressive tax flat (Almeida, 2000).

Macedo *et al*. (1983), Browning & Browning (1985) and Tomaz (2006) recognized that flat tax has huge advantages, including simplicity, economic efficiency and equity. Saavedra *et al*. (2007) and, more recently, Rădulescu (2011) consider that the implementation of flat tax reduces the complexity of the tax system and, in this way, reduces administrative costs, creates incentives for effective tax compliance by taxpayers, creates incentives to savings and investment, reduces the inefficiency for the economy by avoiding double taxation and reducing distortions in investment, and ultimately encourages work, especially for high-income taxpayers who may be those with greater knowledge/skills.

However, Minarik (1985), Aaron & Gale (1996) and Gale (1996) made very severe criticisms of the tax system. The strongest criticism of the flat tax concerns its fairness, pointing out serious flaws in terms of vertical equity. However, Hall *et al*. (1996) refute these criticisms and maintain the view that flat tax advocates equity and is, at the same time, economically efficient.

Indifferent to these criticisms, some Eastern European countries (Slovakia, Estonia, Georgia, Latvia, Lithuania, Romania, Russia, Ukraine and others), from the 1990s, introduced flat tax in their tax systems, both in its original version and in some of its derivatives (Fernandes, 2010).

Keen *et al*. (2006) produced a paper on these experiences and concluded that the results obtained by those countries are all very different, and warn of the possible unsustainability of flat tax, mainly due to two fundamental aspects. The first is related to the lack of consistent tools for taxing the income from capital resulting from the globalization of financial markets, and the second is related to political aspects, resulting from the need to benefit the middle class. Given the high number of Eastern European countries that opted for flat tax and the apparent success of its implementation, Fuest *et al*. (2008) questioned whether it would be possible to introduce a flat tax in a mature European democracy, particularly in Germany. The answer to that question was clear: its introduction would be very difficult, for three main reasons: its limited impact on efficiency, the problematic redistributive effect and the political consequences. Similarly, Paulus & Peichl (2009: 629) state: "In most countries the relative losses in terms of disposable income are high (sometimes even highest) for middle income households in all scenarios. Given that these groups play

usually an important role in the political process of a mature welfare state, these effects might explain why a flat tax is not very popular in Western Europe ".

In conclusion, the difficulties in adopting flat tax lie essentially in its political aspect (Bickley, 2004; Bach *et al.*, 2008; Greyling *et al*., 2008).

3 - Comparative Study

3.1 - Problem and objective

In view of all these criticisms, there are questions as to whether Portugal could make changes to its income tax. Would it be possible to introduce a flat tax? Can flat tax be a viable and reliable alternative in Portuguese Fiscal Economy? Who benefits and who is harmed by IRS and flat tax? Would adoption of a flat tax lead to a decrease in tax revenue?

This research set out from this set of questions and the answers may contribute to the debate about changes in individual income tax in Portugal.

In this sense, we intend to compare the effect on the tax burden of the Portuguese tax system, with the application of progressive rates and proportional rates (flat tax).

3.2 - Method

To carry out this research, we adopt a strategy based on case study methodology. In the opinion of Dul & Hak (2008), case study methodology is particularly suitable for research on economic and social issues. Christians (2010) considers that in current societies characterized by complex social, economic and financial relations, studies focusing on taxes must use the case study, as this methodology is the best alternative to develop new knowledge.

Within case study methodology, the multiple case study, also known as the comparative case study, was chosen. We decided to investigate several "cases", some of which have similar characteristics and others different, to enable comparative analysis. The comparison process underlies the theoretical framework of economic areas, in both Economics and Business Management, which are based on comparative analyses. The comparative analysis is widely used and enjoys a great tradition in the social sciences. To the extent that according to Øyen (1990), for social scientists, the true nature of research is comparison. Recognition of comparative analysis as a key method for knowledge and cognitive activity is synthesized by Dogan & Pelassy (1984) when, to

paraphrase the famous maxim of Descartes: "I think, therefore I am", wrote: "I think, therefore I compare".

The case study, from the perspective of the multiple case study adopted in this investigation, establishes the definition of how many cases should be analyzed. Einsenhardt (1989) considers there is no exact, universal number, i.e., a "magic number", indicating the cases to investigate. However, this author believes that the number of cases to investigate should range between four and ten, because, "with fewer than 4 cases, it is often difficult to generate theory (...), with more than 10 cases, it quickly becomes difficult to cope with the complexity and volume of the data" (Einsenhardt, 1989: 545).

However, the choice of cases to be considered cannot be made at random, as these cases must be selected from as large a sample as possible and, at the same time, must possess similarities and/or differences between them, in order to facilitate their comparison (Iacono, Brown & Holtham, 2011). To respect Einsenhardt's position, it was decided to make a comparative analysis of seven cases representing the universe of Portuguese taxpayers.

3.3 - Assumptions

This work considered the IRS in force in 2013. For flat tax, the following is proposed: 1) the existence of four types of income, dependent activity income, income from business (or from the other independent money-making activity, and from leases), capital property incomes and other incomes; 2) the absence of specific deductions; 3) the absence of deductions at collection; and 4) the existence of two tax rates, 0% for collectable income below minimum subsistence and 19% of the collectable income exceeding minimum subsistence.

Determining minimum subsistence took into account the provisions of article 70 of the IRS code, which provides for a minimum subsistence obtained from the annual value of the minimum wage increased by 20%, which amounts to € 6984. The choice of the 19% rate for income exceeding the subsistence minimum is for two main reasons: 1) to comply with the rate initially proposed by Hall & Rabushka (1981); and 2) to allow the state to obtain higher IRS revenue in 2013. In fact, Carmo & Fernandes (2013) show that a 17.5% flat tax rate would ensure the same tax revenue to the Portuguese State.

The proposed rate of 19% would ensure an increase in tax revenue. Table 1 shows the two tax systems for personal income, IRS and the Flat Tax proposal, allowing observation of the similarities and differences between the two systems.

Table 1- IRS and Flat Tax

	IRS	***Flat Tax***	**Comments**
Type of income	Six categories: - dependent work; - Business and Professional Income; - Capital Income; - Rent income; - asset increases; - Pensions.	Four categories: - dependent activity income; - income from business (or from other independent money-making activities and from leases); - capital property income; - other income.	The big difference between the two systems is based on asset increases.
Specific deductions	Vary depending on the types of income, such as deductions on dependent work, capital, pensions and others.	There are no specific deductions.	The flat tax proposed by Hall and Rabushka (1981) does not allow special deductions.
Deductions from IRS payable	There are numerous deductions from the IRS payable: personal, health expenditure, education, among others.	Deductions are not allowed.	In flat tax, deductions are not allowed (Hall & Rabushka, 1981).
Rates	Rates are distributed by categories and vary between 11.50% and 46.50%	Two rates: - 0% for a tax base lower than the subsistence minimum - € 6,984; and - 19% for a tax base exceeding the subsistence minimum.	The difference between these two systems is the single, identical rate for the entire taxable amount above the minimum subsistence, a characteristic of flat tax.

Source: Authors' calculations based on IRS Code

3.4 - Case studies under review

This comparative study of IRS and flat tax was made from seven real cases for income Category A (dependent work), Category B (commercial and industrial activities,

agricultural, forestry and livestock) and Category H (Pensions). The choice of these categories was based on the work by Vouga (2011), which showed that, taken together, these revenues account for about 90% of gross income subject to IRS. The cases are presented in Table 2.

Table 2 – Case Studies under analysis

	Household	**Category / annual income**	**Deductions from IRS payable**
Case 1	- Married, joint declaration. - No dependents.	Category H: 3.449,04€ and 6.445,60€	Medical expenses = 982,50€
Case 2	- Married, joint declaration. - No dependents.	Category B: 48.350.25€ and Category A: 32.150,02€	Medical expenses = 1.982.88€
Case 3	- Married, single taxpayer. - Dependent, under 3 years old.	Category A: 113.960€	Medical expenses = 1.342,86 € Home mortage interest = 4.258, 32 €
Case 4	- Married, joint declaration. - One dependent.	Category A: 29.700,46€ and 35.489,36€	Medical expenses = 2.412,73€ Education expenses = 3.719,98
Case 5	- Single taxpayer. - No dependents.	Category A: 10.500€	Medical expenses = 122,45€
Case 6	- Married, single taxpayer. - No dependents.	Category H: 38.956,05	Medical expenses = 2.589,23€
Case 7	- Married, joint declaration. - One dependent.	Category B: 65.892,36 18.596,98	Medical expenses = 1.258,07 Education expenses = 2.103,26

Source: authors

Legend: Category A - dependent work; Category H - Pensions; Category B - commercial and industrial, agricultural, forestry and livestock

All cases used in this study are real cases of Portuguese taxpayers and it was decided to formulate two scenarios, namely:

- Scenario 1: Calculation and assessment of IRS made by the Tax and Customs Authority;

- Scenario 2: Calculation and assessment of tax, according to the rules proposed for flat tax.

In addition, the following two assumptions were taken into consideration:
- 2013 data were used due to being the most recent and allowing presentation of the calculation made by the Tax and Customs Authority.
- Only the calculation of IRS for mainland Portugal was considered. The autonomous regions of the Azores and Madeira present exceptions within IRS which, for the simplification of analysis, were not considered.

4 - Findings

In view of what has been stated above, Table 3 presents a summary of the results of this comparative study between IRS (progressive rate) and flat tax. This summary shows that IRS, with progressive rates, benefits (penalizes) taxpayers with lower (higher) incomes. On the other hand, flat tax, which has characteristics of a progressive tax, penalizes (benefits) taxpayers with smaller (higher) incomes. It can also be seen that progressive rates alone do not benefit taxpayers, compared to a flat tax, and that flat tax entails modifying distribution of the tax burden among taxpayers.

Table 3 - Results for the Year 2013

	Scenario 1 (S1) IRS	**Scenario 2 (S2) *Flat Tax***	**Conclusions**
Case 1	0€	0€	The taxpayer does not pay tax in any of the systems.
Differences: S1 vs S2	**0€**		
Case 2	9.008,88€	7679,81€	The flat tax benefits the taxpayer, who would pay less tax in that system.
Differences: S1 vs S2	**- 2.290,01€**		
Case 3	35.332,17€	20.325,44€	The flat tax benefits the taxpayer, who would pay less tax in that system.
Differences: S1 vs S2	**-15.006,73€**		
Case 4	13.907,73€	12.386,07€	The flat tax benefits the taxpayer, who would pay less tax in that system.

Differences: S1 vs S2	**- 1.521,66€**		
Case 5	482,80€	668,04€	The flat tax would penalize the taxpayer.
Differences: S1 vs S2	**+185,24€**		
Case 6	9.343,04€	7.401,65€	The flat tax benefits the taxpayer, who would pay less tax in that system.
Differences: S1 vs S2	**-1.941,39€**		
Case 7	1.680,86€	3.210,60€	The flat tax would penalize the taxpayer.
Differences: S1 vs S2	**+ 1.529,74€**		

Source: authors

5- Final discussion

Carrying out this scientific work can ensure that flat tax respects the Portuguese constitutional principle, which states that tax on personal income shall be single and progressive, as referred to by Carreira (1989, 1996) and Tomaz (2006). Moreover, the single nature of the tax is much greater in flat tax than the current IRS system and at the same time, the fact there is a minimum subsistence guarantees the progressive tax rates. Flat tax can thus be a viable and reliable alternative in the Portuguese economy. In fact, as Rawls (2001) recognized, while admitting the existence of progressive taxation, proportional taxes are part of an ideal solution for a well-ordered society.

It also can be seen that taxpayers with lower incomes pay less with personal income tax than with flat tax, while taxpayers with higher incomes are benefited in the latter system. The adoption of flat tax will lead to a redistribution of the tax burden for taxpayers, as stated by Pereira *et al*. (2005), Tomaz (2006), Fernandes (2008), Nabais (2009) and Sanches (2010).

However, adoption of flat tax in Portugal is not believed to be viable for genuine political reasons, as highlighted by Friedman (1999), Bickley (2004), Bach *et al*. (2008), Greyling *et al*. (2008), Fuest *et al*. (2008) and Araújo (2009). This conviction relates to decision-making processes in democratic societies. And this is even more visible in Portugal.

CONCLUSION

This article reveals that flat tax can be a valid alternative for the Portuguese Fiscal Economy, given that it would respect the constitutional principles of progressiveness and unity of income tax; it is very simple from an administrative point of view; it avoids the myriad of existing deductions in the current tax model; the principle of equity can be ensured by establishing a minimum standard of living appropriate for the Portuguese economic situation; and it may allow an increase in the number of taxpayers subject to tax. However, its adoption is not believed possible for political reasons.

As in any area of economics and management, there are no optimal solutions concerning taxation. Epstein (*apud* Araújo, 2009) states that as an optimal solution, flat tax is less so than the progressive one, but recognizes that, in the absence of an optimal solution, the flat tax can be a sub-optimal one, which means it could be an optimal solution in imperfect societies such as today's. However, as Buchanan (1966) points out, the primary concern of politicians is ensuring their re-election and therefore, hardly any politician in Portugal dare adopt a tax system based on a flat tax.

All research has limitations and here these regard particularly the lack of studies on the effects of the progressive IRS rates prevailing in Portugal on the personal distribution of income or on individuals' disposable income, and so these cannot be used in a comparative analysis. Hence, two avenues for future work would be to study the effect of flat tax on individuals' disposable income and analyze the impact of introducing a flat VAT rate of 19%.

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