The impact of flat tax reforms on the development of Richness in Europe

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European welfare states are under pressure because of population ageing and globalisation. The former increases the need for public funds whereas the latter makes tax bases (sources of public funds) more elastic and tends to increase unemployment of low-skilled workers. The complex tax benefit systems of grown-up welfare states are frequently seen as inappropriate to meet the economic challenges ahead. Therefore, fundamental reforms of the tax system into the direction of simple flat tax systems are proposed.

The introduction of flat rate tax systems is widely seen as a reform which may boost efficiency, employment and growth through simplification and higher incentives. However, these efficiency effects do not come for free. Inequality is likely to increase as a consequence of a flat tax reform implying redistribution from the poor to the rich. These effects have given rise to a debate whether the gap between rich and poor is widening in general. It is widely believed that the rich are getting richer and the poor are getting poorer.

Given this debate, appropriate measures of poverty and richness are of key importance for an empirical analysis. Several income poverty indices have been developed in the long tradition of the literature on measuring poverty. Measuring richness is a less considered field. Empirical studies mainly use the headcount ratio or the income share of rich people (defined by the headcount index) to measure income richness. In a recent paper, we defined a new class of richness indices analogously to well-known measures of poverty[2]. Our approach also takes the dimension of changes and not only the number of people beyond a given richness line into account and therefore allows for a more sophisticated analysis of richness in addition to the traditional headcount index.

The aim of this paper is to analyse the impact of introducing revenue neutral flat tax reforms in European countries on the development of Richness. In a first step, we analyse the development of richness indices over time in Europe (and other OECD-Countries) using micro data from different sources (survey data, administrative tax data). We explain the different developments by taking country specific situations (institutions, distribution of resources) into account and classify the countries into different types of welfare states. In a second step, we rely on EUROMOD, a tax-benefit microsimulation model for the EU15 (which is currently being expanded to the EU25), to compare the

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results across countries in a common framework. We compute the values of these richness indices for different (revenue neutral) flat tax reform scenarios for different years (1998, 2001, 2003 and 2005 for depending on data availability in EUROMOD) and compare the results of these hypothetical reforms with the actual status quo values derived in step one to analyse the impact of flat tax reforms. Again, we explain the differences across countries by taking into account country specific variation in tax benefits systems and the structure of economic resources. Furthermore, we analyse which population subgroups gain and which lose from the introduction of flat taxes for a better understanding of the development of the different richness indices. Moreover, we analyse if and why the results from the different richness indices differ in specific years, countries and/or scenarios for a better understanding of the conceptual differences in definitions of richness indices. Overall, our analysis should contribute to a better understanding of both the measurement of richness and the development of richness over time.

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[2] See Peichl, A., Schaefer, T. and Scheicher, C. (2006). Measuring Richness and Poverty – A micro data application to Germany and the EU-15, CPE discussion paper 06-11, University of Cologne.