

## Some observations on the implementation of progressive and flat taxes in the Albanian tax system

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### Abstract

All taxes discourage something. Why not discourage bad things like pollution rather than good things like working or investment? – a well-known American economist Lawrence Summers has stated.

But anyway, as Benjamin Franklin wrote in a 1789 “...in this world nothing can be said to be certain, except death and taxes”. In these circumstances, taxation is a phenomenon that no one can avoid, but anyway every system should follow the canons of taxation for efficient economic administration as well as for avoiding unnecessary hardships to those who have no capacity to pay.

Adam Smith (1778) identified four famous canons of taxation that are important even nowadays:

Equity: The sacrifice of all citizens must be equal;

Certainty: The tax which each individual is bound to pay ought to be certain and not arbitrary;

Convenience: A good taxation policy must be convenient for the tax payer;

Economy: The cost of collecting tax should be the minimum;

This paper aims the identification of effects of progressive and flat tax implemented in Albania during last decade. This can be achieved by analyzing, personal income tax revenues and tax revenue, for three periods during 2010-2017. The analysis will consist in comparing budget revenues generating from personal income tax as part of total revenue, for periods before and after progressive tax implementation. From this we can find out if there are important differences and which is the trend. The analysis will be carried out through graphs and comparative analysis of time series of revenues from personal income tax as part of total revenue for above mentioned periods.

**Keywords:** progressive tax, flat tax, fiscal system, marginal tax.

### Introduction

Literature in the economic field has considered efficiency and equity as two important goals of economic development. The relationship between these two objectives is well known: policies tend to increase efficiency, but it is also possible to increase inequality. The issue of efficiency-equity relationship is especially expressed in income tax (Mirrlees 1971; Ramsey 1927).

It has commonly been assumed that efficiency is best achieved by the simple use of the amount of tax that does not distort the choice that individuals have made. Meanwhile, vertical equality requires a progressive tax schedule accompanied by specific individual discounts, and returns. In that case, it is said that efficient taxes reduce equality and vice versa. According to financial literature, there are established four tax systems (tariffs), based on fees applied and taxation calculations: proportional, progressive, regressive and flat tax.

*Proportional taxation* is a sort of sistem that taxes different levels of revenues with the same tax rate (Figure 1).

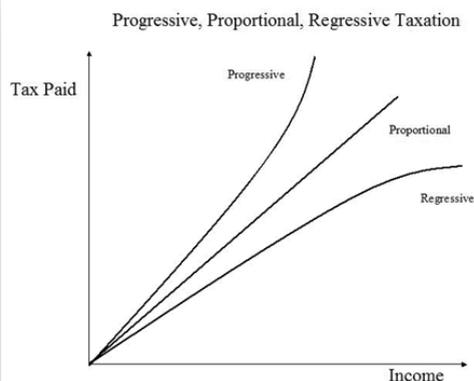
According to proportional system taxpayers are subject to the same tax percentage, regardless of the level of revenues collected. The proportional fee provides and respects one of the basic principles in taxation theory, equality, by providing horizontal tax equality, and therefore the proportional tariff is called horizontal. Meanwhile, there is another important principle in taxation called justice. In particular, it is widely acknowledged that a tax system should have vertical equality: it should distribute the tax burden fairly among people with different payment skills. To resolve this issue, a progressive tariff is applied.

*Progressive taxation* (Figure 1) is one in which the tax rate increases as income increases. The progressive tariff secures and respects another important basic principle in the taxation theory of fair distribution of fiscal burden. This type of tariff provides vertical equality for high levels of income by increasing the tax rate by their size.

Economists believe that progressive taxation is based on the principle of declining marginal utility of wealth, which means that with every next dollar, the utility of dollar declines for the rich. However, for the poor, with every extra dollar earned, its utility increases. This is why the rich should be able to pay more money in taxes. But even for this system there are some cons and pros. Tax systems that implement these progressive tariffs generally penalize rich and businesses that invest and organize their economic units.

Meanwhile, *regressive tax* is quite the opposite. In these terms, higher-income taxpayers pay a smaller percentage of their income than lower-income taxpayers because the tax is not based on ability to pay.

On the other hand, the *flat tax* idea seems simple enough: one tax rate, which applies to everyone, regardless of income. No deductions, loopholes or tax shelters - you multiply your income times the tax rate, and your taxes are done (Flat Tax vs Progressive Tax - Pros and Cons for the US). But anyway, this tax may shift tax burden away from the rich, to the middle and lower class. Economists are of the opinion



that, in general, a flat taxation policy is not friendly to rate of employment and creation of employment opportunities. Regardless of the above, it must be said that the structure of the personal income tax has less space, a lower total marginal rate foreseen by law and less complexity than 25 years ago (Sabirianova Peter, Buttrick, and Duncan, 2010)

**Figure 1.** Progressive, proporcional and regressive tax

Source: <https://11leeco.wordpress.com>

## Personal Income Tax in Albania

There are three main taxes in the Albanian economy such as the tax on wages, profit tax, and tax on consumption. The wage tax includes social and health insurance and personal income tax (PIT).<sup>1</sup>

It can be said that personal income tax was one of the best effective ways to fight evasion, due to non-declaration of real wages as well as informality. According to the Ministry of Finances and Economy, revenues generating from this tax (in percentage of GDP) experienced a high growth in 2007 by 1.5% up from 1% in 2006. This growth rate, with small fluctuations, remains almost constant until 2013. The collection of personal income tax revenues became more controllable after 2007, as the referral wages were implemented and the salary payment was paid through the banking system.

During this period, the most important tax policy was the imposition of a flat tax in 2007 for individuals and profits of companies. Changes in the structure and level of taxation were accompanied by administrative measures that influenced the significant increase in revenues from this tax. Specifically, the flat tax on taxation of individuals influenced the simplification of the system administration and the increase of the taxable base. The data related to total revenue, tax revenues and personal income tax revenues are presented in the table below.

**Table 1.** Total revenue, tax revenue and personal income tax revenue in mln ALL for 2000-2008

Years	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total revenue	130,642	145,639	154,595	167,224	184,355	204,163	229,444	251,555	291,238
Tax revenue	104,112	114,294	128,948	145,388	165,975	183,816	205,523	228,164	264,421
PIT (Personal Income Tax revenue)	4,590	6,300	6,149	6,414	6,852	7,402	8,580	14,850	24,498

Source: Ministry of Finances and Economy

**Table 1.** Total revenue, tax revenue and personal income tax revenue in mln ALL for 2009-2017

Years	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total revenue	298,981	324,721	330,475	330,383	323,705	366,721	381,144	405,074	430,397
Tax revenue	270,830	288,564	303,933	300,860	296,415	335,868	345,569	369,898	398,629

<sup>1</sup> Law 8438 dt 28.12.1998 "On income tax", Article 38

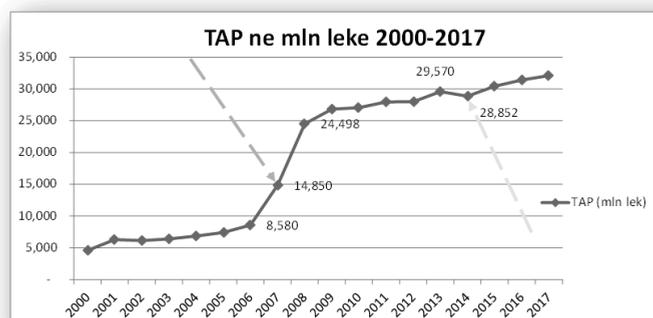
<b>PIT revenue</b>	26,820	27,058	27,967	27,989	29,570	28,852	30,415	31,411	32,102
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Source: Ministry of Finances and Economy

As noted above, during these years, the personal income tax in Albania has undergone significant changes. Until 2005 was applied a progressive tax as the structure in Table 2, Anex 1. In 2007, was passed into a 10% flat tax (Table 3, Anex 1). Meanwhile, the most recent change was done in 2014 with a return into a progressive tax system (Table 4, Anex 1).

On the figure below are presented graphically the data in Table 1 regarding the personal income tax in absolute value.

**Figure 2.** Personal Income Tax 2000-2017.



Source: Ministry of Finances and Economy

As we can see from Figure 2, there are two main “breaks”, which relate with changes in the taxation system of personal income.

The first “break” is in 2007, when revenues from PIT increased from 8.580 million ALL in 2006 to 14.850 million ALL in 2007 and 24.498 million ALL in 2008. This is a very significant element which indicates a positive impact of the transition from progressive to flat tax. After this period, there was stability in personal income tax revenue growth until 2014.

Introduction of flat tax in Albania aimed the development of the tax system that spurs the investment and the business climate, as well as the creation of the tax system which would cause less distortion and will distribute the tax burden in equal manner ([www.minfin.gov.al](http://www.minfin.gov.al)). Actually, developing countries and countries that have not consolidated the tax system accompanied with informality apply flat tax system. In 2007 in Albania, informality was in high levels and the fiscal system had begun to consolidate. Expectations of the flat tax effects in this period, despite their levels, were higher. This is probably due to the fact that in this period the first effects of the global crisis began to feel and the effect of the tax was also influenced by the changes that the Albanian economy suffered for its effect. From the reported dates could be easily noticed that flat tax has increased revenues from personal income tax. Thus, from 1.1% of GDP that covered this tax four years before progressive tax was applied,

it reached approximately 2, 2% of <sup>2</sup> GDP after flat tax was applied.

According to absolute datas of PIT revenues (in mln ALL), average growth rate of revenues from flat tax (for the period 2007-2013) is 1,12<sup>3</sup>.

Second “break”: Referring to Figure No.1, the second break is in 2014, exactly the year in which it was approved and started implementing the progressive tax. We see a decrease in revenues from 29.570 million ALL in 2013 to 28.852 million ALL in 2014. After 2014, it is mainly a steady income growth, reaching the level of revenues of ALL 32.102 million in 2017. The average rate of revenue growth for the period of implementation of the progressive tax 2014-2017 is 1,036.

As noted in the literature, the characteristic of the progressive taxation is the establishment of vertical equality, which consists of distributing the tax burden fairly among individuals with different payment skills. It is evident that those with higher incomes will pay more than those who have lower incomes. Due to this fact, if we compare the average annual revenues generated in the period 2007-2013, considered as the period of flat taxation, with those generated in the period 2000-2006 and 2014-2017 considered as periods of progressive tax, we note that:

- In 2000-2006 (period I) average revenue from PIT is 6,612 mln ALL in absolute values/terms or approximately 3.82% in relative terms (as total revenue %) with a standart deviation of 1224 mln ALL dhe coefficient of variation <sup>4</sup> 19%.

Descriptive Statistics (A)

	N	Minimum	Maximum	Mean	Std. Deviation	Variance
Tap1	7	4590.00	8580.00	6612.4286	1224.34498	1499020.619
Valid N (listwise)	7					

Source: author calculation

- In 2007-2013 (period II) average revenue from PIT is 25,536 mln ALL in absolute values/terms or approximately 8.24% in relative terms (as total revenue %) with a standart deviation of 4957 mln ALL and coefficient of variation 19%.

Descriptive Statistics (B)

	N	Minimum	Maximum	Mean	Std. Deviation	Variance
Tap2	7	14850.00	29570.00	25536.0000	4957.03719	24572217.667
Valid N (listwise)	7					

Source: author calculation

- In 2014-2017(period III), average revenue from PIT is 30,695 mln ALL in absolute values/terms or approximately 7.8% in relative terms (as total revenues %) with a standart deviation of 1410 mln ALL and coefficient of variation 5%.

<sup>2</sup> Ministry of Finances and Economy, Midterm Budget Programme 2015-2017.

<sup>3</sup> Average growth rate  $K = \sqrt[n-1]{Y_n/Y_1}$ .

<sup>4</sup> Coefficient of variation  $Kv = \frac{\sigma}{x} * 100$ .

Descriptive Statistics (C)

	N	Minimum	Maximum	Mean	Std. Deviation	Variance
Tap3	4	28852.00	32102.00	30695.0000	1410.36095	1989118.000
Valid N (listwise)	4					

Source: author calculation

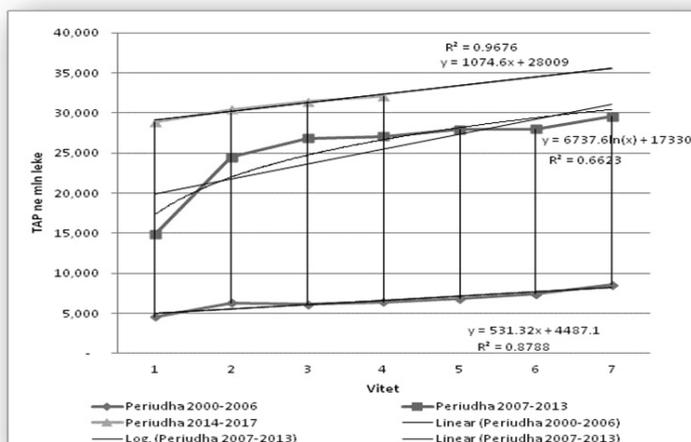
Descriptive Statistics (D)

	N	Minimum	Maximum	Mean		Std. Deviation	Variance
				Statistic	Std. Error		
TAP1 <sup>1</sup>	7	3.51	4.33	3.8214	.10173	.26916	.072
TAP2	7	5.90	9.10	8.2429	.40700	1.07681	1.160
TAP3	4	7.50	8.00	7.8000	.10801	.21602	.047
Valid N (listwise)	4						

Source: author calculation

From the reported dates and figure of three periods under study, could be easily noticed that the trend of the two periods representing the progressive tax is the same (linear) and the coefficient of determination is high. Meanwhile, the trend of the second period, considered as the period of flat tax, approaches the logarithmic function with a moderate probability coefficient.

Figure 3. PIT trend referring to 3 periods (in mln lek)

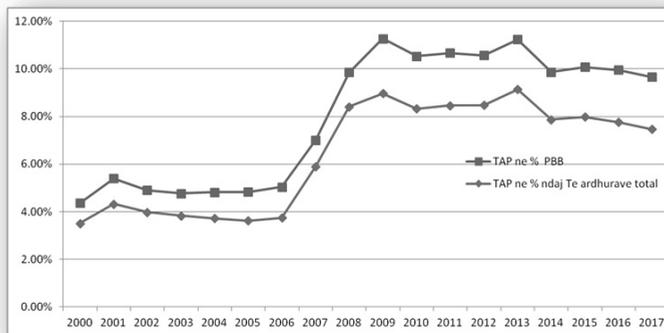


Source: Ministry of Finances and Economy

By analysing datas on PIT as total revenue % and PIT as GDP % (Figure 4), we can

see that the trend of two graphs is the same. On the other side, there is significant difference if we compare this trend with the one presented in the Figure 2 (where the datas are in absolute terms). If revenues from PIT in absolute value/terms after 2014 increase (Figure 3), PIT revenues in percentage of GDP decrease (Figure 4).

**Figure 4.** Personal Income Tax as Total Revenue % and as GDP % (2000-2017)



Source: Ministry of Finances and Economy (Midterm Budget Programmes)

## Conclusions

Based on the analysis of data on revenues in million ALL realized by PIT, we note that the average revenue in period III is higher (30,695 mln ALL) than period II and with a lower standard deviation. This indicates a positive effect of the progressive tax. Average growth rate of revenues in period II (1.12) is higher than the one in period III (1.036), which shows a rapid effect of medium-term income growth as a result of the flat tax comparing with progressive tax. On the other hand, while analyzing PIT revenues in percentage of total revenues, can not be observed the same result. The average percentage of total revenue in period III is 7.8% and lower than in period II, which is 8.24%. This indicates that in the macro system the implementation of progressive tax is associated with indirect effects that negatively impact on the ratio of total incomes (Descriptive Statistics (D)). The data show that regardless of the period (periods I and III, figure 3) in which the progressive tax is implemented, the trend of revenue realization is the same and with a relatively high R correlation coefficient. Meanwhile, the trend of the flat tax period (period II), is a logarithmic one until 2010. We consider that the trend of revenues from PIT, during this period, has been influenced by the global crisis as well as the high level of informality. From the literature review on the tax system we conclude that the structure of the tax system in a given period of time should be adapted to the current conditions of business development, development needs and in line with socio-economic development objectives of the country. The tax system is a crucial element in creating premises or difficulties on business development of a country economy. It also affects social equality and the level of employment. From this point of view, the discussion on which tax system is to be implemented in a country depends on a number of factors

such as: development level of the country or economic model of development, taxation administration structure, individuals and businesses taxation culture and other factors which play an important role.

### Restrictions

The above analysis is focused only on primary and secondary data analyzes, published by central institutions on the value in million ALL of PIT revenues and the percentage of GDP or total revenue. Meanwhile, macroeconomic changes occurring in different periods have not been taken into consideration in this analysis. For a further analysis, it is also required to analyze the level of inflation, the level of informality and unemployment by considering them as factors with significant impact on the data on PIT revenues, which is not considered in the above analysis.

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### Annex 1.

**Table 2:** Progressive tax table, referring to the Law no. 9458, date 21.12.2005

2005			
Taxable revenues (monthly)	PIT		Tax rate (%)
	Over (ALL)	Up to(ALL)	
0	14 000	0	+1 % of the amount over 0 ALL
14 000	40 000	140	+ 5% of the amount over 14 000 ALL
40 000	90 000	1 440	+ 10% of the amount over 40 000 ALL
90 000	200 000	6 440	+ 15% tof the amount over 90 000 ALL
200 000	More	22 940	+ 20% of the amount over200 000 ALL

**Table 3:** Flat tax table, referring to the Law no. 9766, date 09.07.2007

2007			
Taxable revenues (monthly)	PIT		Tax rate (%)
	Over (ALL)	UP to (ALL)	
0	10 000	0	0 %
10 001	30 000		10% of the amount over 10 000 ALL
30 000	More		10% of the amount over 0 ALL

**Table 4:** Progressive tax table, referring to the Law no. 177/2013

2014		
Taxable income (monthly)		Tax rate (%)
From	To (including)	
0	30 000	zero %
30 001	130 000	+ 13 % of the amount over 30 000 ALL
130 001	More	13 000 lekë + 23 % of the amount over 130 000 ALL