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Lessons from Abroad

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SOFIA, Bulgaria.

Can you name a country that has a flat 10 percent income tax on both personal and corporate income, and that is also running a budget surplus of 8 percent of gross domestic product (the equivalent of the United States running a budget surplus of more than $1 trillion)? The surprising answer is Bulgaria, formerly one of Europe's most backward countries.

Most of the former communist countries of Eastern and Central Europe have instituted flat-rate income tax systems. Estonia was the first, and Bulgaria is one of the most recent, having only moved to the 10 percent flat rate at the beginning of this year. The flat rate for Bulgaria was first proposed by exceptionally talented young economists affiliated with the Institute for Market Economics (IME), the country's leading free-market think tank.

Economists in the Finance Ministry claimed that such a drastic cut in the top income tax rates would cause tax revenue losses, resulting in a large budget deficit. However, the opposite occurred, just as IME economists had predicted.

The problem was that the economists who were then in the Finance Ministry were still using old-fashioned, static revenue models that did not capture the behavioral effects of such a tax change. Unfortunately, the tax revenue models still in use in the United States by Congress and even many private organizations are largely static rather than dynamic models, and therefore incorrectly project tax changes.

If Sen. Barack Obama's economists would run their proposed tax increases on small businesses, upper-income individuals, and capital gains through a proper and full dynamic model, they would find that the projected revenue gains from these tax rate increases would be largely nonexistent. If Sen. John McCain's economists would run their proposed tax rate cuts through, again, a full dynamic model, they would find they should be cutting tax rates even further for the U.S. economy to reach its full potential.

The income tax rate cut in Bulgaria caused its economy to grow more rapidly, and hence there was a surge in the VAT (value-added tax) and other consumption tax revenues, as well as a reduction in the underground economy. This year, the Bulgarian economy will grow about 4 times faster than the average of the European Union (of which Bulgaria is a member). Given the success of the flat tax, many who initially opposed it now claim to have supported it all along.

Bulgaria privatized its banks, did not create semi-socialist mortgage banks like Fannie Mae and Freddie Mac, has required banks to keep adequate reserves (which now average 13 percent, about double the U.S. average), and now is in a much better position to weather the international financial crisis.

Bulgaria, as all European countries, has a government-run health-care system, and, like all such systems, provides an inferior service. But Bulgaria has allowed (unlike Canada and many other countries) private doctors and hospitals to operate on a fee-for-service basis. As a result, the private medical sector is rapidly growing as more and more Bulgarians become wealthy enough to pay for high-quality medical care, rather than queue up for poorly run government services. Bulgaria is now also developing a significant private medical tourist industry as Americans and Europeans seek high-quality, but lower-cost, medical care for non-time-sensitive or elective procedures.

Perhaps most importantly, Bulgaria has gone through a major shift in its cultural mind set from the communist period. After a slow start with economic reform, the country has been rapidly catching up. The economy has been growing steadily and the great exodus of Bulgarians to other countries appears to be abating, as many Bulgarians now return because of the new economic opportunities.

Foreign investment is increasing, and recently Hewlett Packard transferred 100 jobs from India to Bulgaria. A successful American businessman, who was born in Bulgaria and fled many years ago during the communist dictatorship, just told me that after almost two decades of economic transition he is now ready to invest in Bulgaria for the first time. A former, very high-ranking Bulgarian official, who was not always friendly to free-market ideas, commented at an IME conference this past week that there are only free-market economies because non-free market economies always fail. That understanding is now deeply ingrained in many Bulgarians, in part, due to the exceptionally fine work of the IME.

Bulgaria is not without its problems, notably corruption. The EU has recently withheld development funds from Bulgaria because of its slow progress in cleaning up the corruption, particularly in the judicial system. Bulgaria also suffers from having a very low birthrate and an aged population, which means there is only about 1 worker for every person who receives a pension or other government assistance (as contrasted with about a 3-to-1 ratio in the United States).

For two centuries, the U.S. economic system has served as the model for much of the rest of the world. But, like many institutions and individuals who have enjoyed great success, the United States has allowed itself to get fat and lazy and to drink from the poison chalice of claims that government is the solution rather than the problem. Many Bulgarians and other peoples who had experienced full socialism and communism understand the dangers of too much government more than all too many Americans.

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