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# Iceland Joins the Flat Tax Club

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Iceland has joined a growing list of nations that have sharply cut their corporate tax rates and adopted flat-rate individual income taxes. With the expiration of a surtax last year, individuals now pay a flat rate of 22.75 percent of their taxable income to the central government.[1] Local governments also tax income at a single rate, pushing the combined flat rate up to 36 percent.

Iceland's system is not a pure Hall-Rabushka flat tax.[2] Not only is the rate high, but Iceland retains some double taxation of saving and investment, as well as a few special tax preferences. Compared to other developed nations, however, Iceland has moved dramatically in the direction of a tax system that collects a given amount of revenue in a way that minimizes economic distortions.

## Iceland's Tax System

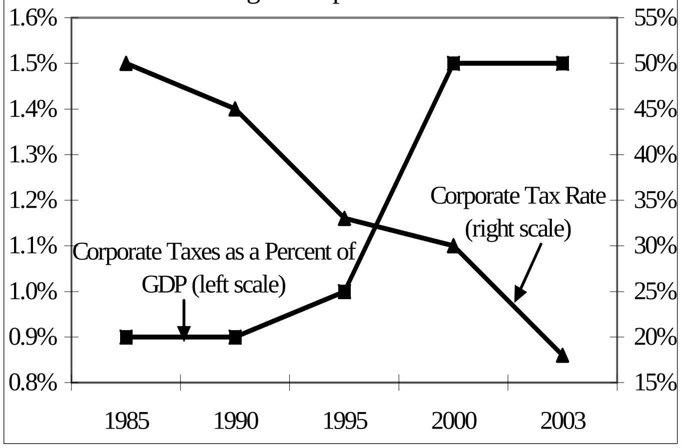
Iceland has cut its top tax rates to reduce penalties on productive activities. As recently as 10 years ago, Iceland's central government imposed a top individual tax rate of 35.41, comprised of a general tax rate of 30.41 percent and a surtax on higher incomes of 5.0 percent. Combined with local income taxes of almost 12 percent, the government was taking nearly half of additional income earned by Iceland's most productive taxpayers.

Under recent reforms, the central government's general income tax rate has fallen by more than seven percentage points and the surtax has been eliminated. With the addition of the local income tax, which has increased slightly, the combined top tax rate is now 36 percent.

As is the case in almost every flat tax country, Iceland's system has a substantial tax-free threshold. Taxpayers get a credit of about $5,000 per adult and $2,000 per child. In addition to those family benefits, there are tax preferences for housing and seamen.

Iceland has a relatively modest payroll tax of about 6 percent, technically paid by the employer. Note that almost all workers in Iceland have employer-based pensions based on private savings. Iceland also has an onerous value-added tax with rates between 14 and 24.5 percent.

Figure 1. Iceland's Lower Corporate Tax Rate Yields Higher Corporate Tax Revenue




Source: Iceland Ministry of Finance.

Iceland's most dramatic reforms are in corporate taxation. The corporate income tax rate is 18 percent, which is among the lowest in the industrial world. The corporate tax rate has been cut steadily from 50 percent in the late 1980s, to 33 percent by the mid-1990s, and to just 18 percent by 2002. The rate cuts have created a powerful increase in investment incentives and boosted economic growth. Rather than creating a revenue loss for the government, Iceland's corporate tax cuts have coincided with rapidly rising corporate tax revenues. Figure 1 shows this "Laffer curve" effect.

## Reforms Have Made Iceland a Nordic Tiger

In addition to the flat tax for individuals and dramatic corporate tax rate reductions, Iceland has made other important reforms. It reduced its estate tax rate to 5 percent, implemented a flat tax of just 10 percent on capital income, repealed a turnover tax on business, and abolished a wealth tax.

Another economic reform was the creation of private property rights for fisheries, a policy that is being adopted by other nations.[3] Iceland also granted independence to its central bank to create a stable monetary policy, and it has privatized numerous businesses.[4]

All these reforms have helped Iceland climb from 26th to 9th in the *Economic Freedom of the World* rankings between 1990 and today.[5] Greater economic freedom has created large benefits for average citizens of Iceland. According to the World Bank, Iceland is now one of the world's richest nations, ranking in the top 10 using either of two different methodologies.[6] Unemployment in Iceland is almost nonexistent, dropping to less than 2 percent in 2006, according to the International Monetary Fund.[7]

The Organization for Economic Cooperation and Development also has a positive report. It notes that "Iceland's economy and per capita income have grown at an impressive pace since the mid-1990s, making the country one of the most prosperous in the OECD."[8] In particular, Iceland's "real GDP has grown by 4 percent per annum, significantly bettering OECD growth over that period … [and] making the country the fifth-wealthiest in the OECD on that benchmark."

**The Global Shift to Flat Taxes**

Although jurisdictions such as Hong Kong, Jersey, and Guernsey have operated successful flat tax systems for decades, the modern-era flat tax revolution began with Estonia in 1994. The other two Baltic nations, Latvia and Lithuania, quickly joined the flat tax club, followed by Russia in 2001. Ukraine, Slovakia, Romania, and Georgia were part of the second wave of flat tax nations.[9]

Table 1 shows that the current club of flat tax nations includes not only Iceland, but also Mongolia, Macedonia, and Kyrgyzstan.[10] And because of tax competition, it is likely that more nations will join the flat tax club.

**Conclusions**

Iceland's flat tax has a high rate compared to flat taxes in other countries. Other reforms, particularly the low corporate rate and the 10 percent tax on capital income, are more dramatic. From a political perspective, however, the Iceland reform is remarkable. It is the first time a Western nation has decided to no longer impose discriminatory tax rates on more successful taxpayers. Tax reform and economic liberalization have helped Iceland prosper. It remains to be seen whether other industrial nations will learn from Iceland's success.

Table 1. Flat Tax Nations: Top Income Tax Rates, 2007

| Country | Individual | Corporate |
|---|---|---|
| Estonia | 22.0% | 24.0% |
| Georgia | 12.0% | 20.0% |
| Hong Kong | 16.0% | 17.5% |
| Iceland | 36.0% | 18.0% |
| Kyrgyzstan | 10.0% | 10.0% |
| Latvia | 25.0% | 15.0% |
| Lithuania | 27.0% | 15.0% |
| Macedonia | 12.0% | 12.0% |
| Mongolia | 10.0% | 25.0% |
| Romania | 16.0% | 16.0% |
| Russia | 13.0% | 24.0% |
| Slovakia | 19.0% | 19.0% |
| Ukraine | 15.0% | 25.0% |
| Flat tax countries (avg.) | 17.9% | 18.5% |

Source: Author. Figures include national and subnational rates. Estonia's corporate rate for retained earnings is zero.

[1] Ministry of Finance, Iceland, "Principal Tax Rates," July 2006, http://eng.fjarmalaraduneyti.is/media/Taxes/Principal_tax_rates_2006.pdf.
[2] Robert Hall and Alvin Rabhushka, *The Flat Tax*, 2d ed. (Stanford CA: Hoover Institution Press, 1995).
[3] Birger Runolfsson and Ragnar Arnason, "Individual Transferable Quotas in Iceland," in *Fish or Cut Bait! The Case for Individual Transferable Quotas in the Salmon Fishery of British Columbia*, Fraser Institute, August 1997, www.fraserinstitute.ca/shared/readmore.asp?sNav=pb&id=257.
[4] David Oddsson, "Iceland's Economic Performance," Address to the American Enterprise Institute, Washington, June 14, 2004, http://eng.forsaetisraduneyti.is/minister/speeches-and-articles/nr/1391.
[5] James Gwartney and Robert Lawson, *Economic Freedom of the World: 2006 Annual Report*, Fraser Institute, 2006, www.cato.org/pubs/efw/efw2006/efw2006-3-a-k.pdf.
[6] World Bank, "GNI per Capita 2005, Atlas Method and PPP," World Development Indicators database, July 1, 2006, http://siteresources.worldbank.org/DATASTATISTICS/Resources/GNIPC.pdf.
[7] International Monetary Fund, "IMF Executive Board Concludes 2006 Article IV Consultation with Iceland," August 8, 2006, www.imf.org/external/np/sec/pn/2006/pn0692.htm.
[8] Organization for Economic Cooperation and Development, "Economic Survey of Iceland, 2006," Policy Brief, July 2006, www.oecd.org/dataoecd/22/45/37215813.pdf.
[9] Daniel Mitchell, "Eastern Europe's Flat Tax Revolution," *Tax Notes International*, March 14, 2005.
[10] See recent reports by Alvin Rabushka, *The Russian Economy*, www.hoover.org/research/russianecon.