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THE PERSONAL INCOME TAX

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A recent paper argues persuasively that the two basic pillars of taxation in most countries are the income tax and the VAT (Barreix and Roca 2007).[1] The authors argue that the VAT is excellent as a revenue raiser and works best if it is applied in the simplest and most neutral fashion possible—that is, on as broad a base as possible and preferably at a uniform rate. This conclusion seems well-founded as has been argued at length recently (Bird and Gendron 2007). More controversially perhaps, Barreix and Roca (2007) also argue, with special reference to Latin America, that most countries need to pay more attention to the potential of the personal income tax (PIT) both as a revenue raiser and as an important element of social cohesion. PIT plays the second of these roles both because revenue raised from this source comes mainly from higher income groups and because the personal nature of the tax strengthens the connection between taxpayers and the state.

Given the relative unimportance of personal income taxes in most developing countries this argument is at first sight perhaps somewhat surprising. PIT revenues are often three to four times corporate tax revenues in developed countries, but in developing countries corporate tax revenues usually substantially exceed PIT revenues.[2] As a percentage of GDP, personal income tax revenues in developed countries average about 7% of GDP as compared to about 2% for developing countries. Moreover, as Bird and Zolt (2005) note, in many developing countries personal income taxes often amount to little more than taxes on labor income. At the same time, although little revenue is received from capital income, income taxes often impose high marginal effective rates on investment and hence discourage growth.[3]

PITs like these might seem at first glance to deliver neither equity nor growth. In reality, however, since even defective PITs are generally applied only to labor income accruing in the modern sector they are inherently progressive particularly in less developed countries. Studies of tax incidence invariably show that the only moderately progressive part of the tax system in most countries is the PIT.[4] To achieve both equity and growth, ideally the PIT would have a significant average rate—thus producing revenue—but a modest marginal rate in order to avoid distorting economic decisions in unduly costly ways.

As Barreix and Roca (2007) argue, in many countries societal disaffection with the inequities accompanying growth often seems to require some degree of visible fiscal correction if growth-facilitating policies are to be politically sustainable. There is thus an important continuing role in most fiscal systems for the income tax—the *mirror of democracy* as one fiscal historian labeled it (Webber and Wildavsky 1986). A properly designed tax regime can in most countries generate sufficient revenue to finance needed social and public services in a mildly progressive (or at worst proportional) way. Much of the revenue in developing countries will inevitably come from VATs and other consumption taxes, but most of the progressivity will equally inevitably have to come from income taxes.

[1] The paper actually says there are three pillars—the third being pension contributions—but discussion of this issue is beyond the scope of the present paper.
[2] See Tanzi and Zee (2000). These data may be misleading in that some countries classify income from unincorporated business as corporate (business) rather than personal income.
[3] See Poirson's (2006) description of the current Indian tax system for a depressingly good example of such a PIT.
[4] In addition to the studies cited in Barreix and Roca (2007) see the broader survey in Chu *et al.* (2000).

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Most developing countries thus need both income and consumption taxes, but they need the right kind of each: the details of design and administration matter a lot. Consumption taxes are discussed briefly in another note in this series. This note focuses on personal income taxes.[5]

In the not too distant past, most tax policy advisors saw the personal income tax as the center of the tax universe. The main challenges in developing countries were considered to be, first, to adopt a good comprehensive income tax with adequately progressive rates and, second, to put into place a sufficiently effective tax administration to spread the cost of government among members of society in accordance with some appropriate concept of *ability to pay*. The appropriate base for such a tax was thought by most to be a comprehensive base including all forms of income (the Haig-Simons concept).

Despite the defects of this model in practice, a progressive income tax remains an important and sometimes critical visible symbol of concern with the inequality usually accompanying growth. Policymakers in most countries should therefore be concerned with how to strengthen the PIT. The key question is whether to retain a comprehensive income tax approach, to revert to some updated version of the older presumptive approach, or to introduce some explicit schedular elements into the income tax as in the dual income tax systems of the Nordic countries under which a flat rate is applied to income from capital and a mildly progressive rate to income from labor.

Although all these matters relate to the proper base of the tax, to many people tax rates seem to be the most important part of the tax system. Certainly the most striking feature of recent decades has been the steady decline in the level and degree of progressivity of most PIT rate structures around the world. In Latin America, for example, the average top rate on personal income declined from 51 in 1985 to 28 percent in 2003 (Lora and Cardenas 2006). Similar trends may be found elsewhere in the world. Arguably, the result has been very little if any decrease in the effect of progressivity of tax systems in most developing countries. Some would like to continue this movement to reduce progressivity by introducing a flat or single PIT tax rate, as has been done in a number of former command economies in recent years. Because such taxes continue to be applied only to income above a certain threshold limit, they continue to be progressive to a certain extent. Nonetheless, although this note argues for a flat tax on capital income, there seems little reason to extend this argument to require flat taxes on all income.[6]

Improve the Comprehensive Income Tax Approach

For a developing country to have a viable comprehensive personal income tax system the principal need is usually to expand the tax base. Depending on the country, this might involve taxing interest on government bonds, taxing non-cash compensation to employees, taxing residents on portfolio income earned outside the country, taxing capital gains, and eliminating the use of tax holidays. A separate paper could be devoted each of

[5] What follows draws in part on Bird and Zolt (2005). For a detailed recent discussion of personal income tax issues in developed countries, see OECD (2006).

[6] A good summary of the experience with flat taxes may be found in Saavedra (2007).

these issues.[7] Countries should also seek to reduce the portion of the economy operating outside the tax system through such means as devoting greater administrative resources to taxpayer registration and compliance, devising simplified rules for taxing small businesses, professionals and agriculture, and increasing the costs of operating in the informal economy while increasing the benefits of operating in the formal economy. In addition, withholding regimes could be expanded, for example, by expanding the definition of employee for tax purposes beyond the requirements for employment law or prohibiting businesses from deducting payments without either withholding or information reporting.

All of these approaches have been tried at various times in different places. In some circumstances, they have worked fairly well. In others, they have not. The question is always whether the game is worth the candle: would the incremental gain in terms of additional tax revenue and progressivity justify the political, administrative, and economic costs? Practical experience suggests that in developing countries the costs and risks of following this strategy are likely to prove high relative to its chance of success. Most studies end up recommending that countries lower (not raise) marginal rates, coupled with broader bases with respect to both labor (informal sector, fringe benefits) and capital (tax incentives, interest, perhaps real estate gains) income, heavier reliance on withholding (e.g. by banks) and, above all, better administration (taxpayer identification numbers, outsourcing routine data processing, case-tracking systems, and above all better auditing). In effect, what this advice amounts to is that a better comprehensive income tax depends almost entirely on significantly improving tax administration. While better administration is certainly needed in most developing countries, this takes us well beyond the scope of the present note.[8]

The Presumptive Approach

A common administrative stopgap in many countries is to impose taxes on bases that are administratively determined rather than self-assessed by taxpayers. Presumptive systems may, for example, calculate taxable income based on key factors that are presumably associated with income generation such as sales, turnover, number of employees, size of firm, assets of the taxpayer, etc. The estimated tax base is typically calculated based on coefficients for different factors applied to specific taxpayers or specific types of taxpayers (such as certain sized enterprises in particular industries). The idea is to use data available to officials to capture at least some minimum level of tax from those taxpayers who are considered to be unreliable sources of information on their own activities.

Most presumptive tax systems have two thresholds. There is a minimum threshold below which activities are not subject to tax and a maximum threshold above which taxpayers no longer quality for the presumptive tax regime and are subject to tax under the regular tax system.[9] Too

[7] See, for example, OECD (2006a) on the taxation of capital gains.

[8] For a recent assessment of administrative reform needs and possibilities, see Bird (2004).

[9] A major flaw of such regimes in many countries is that they do not include explicit plans for "growing' taxpayers out of the special system into the normal system of taxation. This serious design flaw increases the potential unintended impacts of special regimes especially since the political economy of presumptive systems almost guarantees that the tax burdens enjoyed by those in such regimes are sufficiently favorable to make them an attractive place to stay and provide no

high an exit threshold undermines the regular tax system and invites too many participants into the special regime. An entry threshold that is too low may discourage small business activity and may impose tax liability on persons who should not be in the tax system. Nonetheless, those subject to presumptive tax regimes often prefer them because they shelter them from some of the complexity of the tax system and the rapacity of tax officials. The tax administration may also prefer presumptive regimes because they no longer have to deal with troublesome small taxpayers and can concentrate on the big taxpayers, where the revenue is. Politicians may also prefer presumptive regimes, because the small taxpayer community is large and vociferous and because they think it costs them little or nothing in terms of revenues or is perhaps even a revenue gainer.

However, those concerned with the equity, efficiency, and long-term development of sound tax systems should be less sanguine about presumptive tax regimes. Such systems are seldom well designed and almost never well integrated with the regular tax system. To a limited extent, presumptive tax approaches may play a useful supporting role in establishing and enforcing some form of taxation on self-employment income in developing countries. From the point of view of the longer-term development of sustainable tax system, however, they are usually a dead end.

De-Link the Taxation of Income from Capital and Income from Labor

On the whole, the simplest and most promising approach to taxing personal income more effectively in developing countries is to establish separate regimes for the taxation of labor and capital.

Separate treatment of income from capital and labor of course has its own difficulties but the dual income tax approach has two major advantages in developing countries: rationalization of the taxation of capital income and improved enforcement and compliance. Adopting a single flat tax rate on capital income provides an opportunity to expand the tax base to include types of income that were previously exempt from taxation, such as interest on bonds. It should also improve enforcement and compliance. A uniform rate should allow for more effective "final" withholding tax taxes.[10]

It may seem unfair that capital income is subject to lower tax rates than (some) income from labor. The issue of fairness is more complicated than appears at first examination, however. Sometimes, separate tax regimes for taxing labor and capital income may make everyone better off. Suppose, for example, that under the typically flawed current PIT the tax rate for all income is 30% and total tax revenue is $100 million, of which $20 million is from taxes on capital and $80 million is from taxes on labor (including self-employed). If a schedular tax on

incentive to graduate. For further discussion, see Bird and Wallace (2004).

[10] Usually, in the Nordic models of dual income taxes the same rate is applied to business and capital income. Uruguay, in contrast, has adopted a dual rate dual income tax with the rate on business income being set at the top rate of the labor income tax (25%) and the rate on capital income close (12%) to the bottom rate of the labor income tax (10%) (Barreix and Roca 2007). This system obviously limits the scope for arbitrage between labor and business income; Barreix and Roca (2007) assert that arbitrage between business and capital income is adequately dealt with by such rules as limiting interest deductions to the ratio between the rates on capital and business income (i.e. 12/25). Obviously, in practice the control of all tax arbitrage when rates differ ultimately depends on the quality of tax administration.

capital income (at, say, 20%) that is more effective at taxing capital is adopted so that tax revenues from capital income increase to $30 million and the revenue requirement remains the same, only $70 million is then required from labor income—allowing a rate reduction to, say, 27%. Everyone is better off and, since capital income comprises a higher proportion of the income of the rich than of the middle class—the poor in developing countries are not subject to PIT—the resulting income tax is almost certainly more progressive than the previous comprehensive tax—even if that tax had progressive rather than proportional rates.

A comprehensive progressive income tax may still look best to many tax analysts from an equity perspective, but as a rule in developing countries it is considerably less desirable from both economic and especially administrative perspectives than a dual income tax. A consumption tax may be even better from the latter two perspectives, but as argued above it is likely to be less acceptable politically and perhaps less desirable from an equity perspective. *The dual income tax—a schedular income tax with a proportional rate on capital income close to the lower rate of the wage tax—may prove an acceptable compromise.* A modestly progressive tax on wage income and as comprehensive a low-rate tax on capital income as possible is perhaps the best one can or should aim for in developing countries. Certainly such a tax would constitute a major improvement over the superficially progressive and superficially comprehensive PITs normally found in such countries.

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