

# The limited role of the personal income tax in developing countries

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## Abstract

In this paper we examine the re-distributive role played by personal income taxes in developing countries. We begin with some initial reflections on the re-distributive role of the tax system. We then consider the relative success of developed and developing countries in using tax systems to redistribute income. Finally, we examine some alternatives in reforming the personal income tax, as well as options available to developing countries in designing and implementing more progressive fiscal systems.

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## 1. Introduction

Inequality has increased in recent years in both developed and developing countries. Even in Asia, the most equal developing region, income inequality rose slightly in the 1990s after holding steady in the 1980s. The poor are relatively poorer and the rich are relatively richer in developing than in developed countries. On average, those in the top income decile in Asia commanded 14 times as many resources as those at the bottom, compared to 12 times in the developed countries. In developed countries, the income tax, especially the personal income tax, has long been viewed as the primary instrument for redistributing income and wealth. Should developing countries rely on the personal income tax for re-distributive purposes?

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We think not, for three reasons. First, the personal income tax has done little, if anything, to reduce inequality in many developing countries. This failure is not surprising given that in many such countries, including those in Asia, personal income taxes are neither comprehensive nor very progressive—they often amount to little more than withholding taxes on labor income in the formal sector. The personal income tax plays such a small role in the tax systems of many developing countries that it is unlikely that this tax could have a meaningful impact on distribution. Second, it is not costless to pretend to have a progressive personal income tax system. Tax systems generate real administrative, compliance, economic efficiency and political costs. The costs associated with badly designed and badly administered personal income tax systems likely exceed the costs associated with other taxes. Third, there are opportunity costs as well. If countries want to use the fiscal system to reduce poverty or reduce inequality, alternative approaches merit consideration.

We do not call for eliminating or minimizing the personal income tax. We believe that despite its limitations, the personal income tax plays an important role in developing countries. But neither do we praise these taxes as effective instruments to redistribute income. If policy makers seek to reduce inequality or reduce poverty, they need to look elsewhere. Countries need to make better use of their expenditure programs in targeting resources to the poor. The distributional consequences of consumption taxes are often more important than those of the personal income tax. Countries can also consider alternatives to taxing income other than the current comprehensive income approach.

We begin in Part II with some initial reflections on the re-distributive role of the tax system. Part III then considers the relative success of developed and developing countries in using tax systems to redistribute income. Part IV examines some alternatives in reforming the personal income tax, as well as options available to developing countries in designing and implementing more progressive fiscal systems. Part V concludes.

## **2. The distributive role of the tax system**

Countries use taxes for many purposes—to raise revenue to fund government services, to encourage or discourage certain types of behavior, to correct market imperfections, and to change the distribution of income or wealth. At a fundamental level, however, the main reason for a tax system is to allocate the cost of government in some fair way. Achieving a politically acceptable degree of fairness in taxation that allows governments to extract funds from the private sector without adding to inflationary pressure is an essential ingredient in achieving the quasi-constitutional equilibrium necessary to maintain a sustainable political structure (Bird, 2003). A country's tax system is both an important and a highly visible symbol of its fundamental political and philosophical choices. Differences in views of the appropriate re-distributive role of taxes will lead to different tax system designs.

Ideas about the appropriate distributive role of taxation have changed over time. In the 1950s and 1960s, for instance, tax policy discussion reflected optimism about the possibility of constructive state action to remedy perceived ills. Most analysts at the time assumed that a highly progressive personal income tax (with marginal rates ranging up to 70% or more) constituted the core of an ideal tax system. Not only did the need for redressing inequality through fiscal means seem obvious, but the ability of taxes to do the job was largely unquestioned. Indeed, optimists thought that both revenue generation and redistribution could be achieved simply by imposing high effective tax rates on income. The costs of doing so received little attention because the depressing effects of taxes on investment, saving and growth were considered to be small. The conventional wisdom was that developing countries could solve their fiscal problems simply by

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