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Dual Income Taxation: A Promising Path to Tax Reform for Developing Countries

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Summary. — The dual income tax combines a progressive tax on labor income and a lower flat tax on income from capital. Unlike flat tax systems, a dual income tax provides developing countries greater flexibility in addressing tax competition while retaining progressivity. Countries could use the move to a dual income tax system not just as an opportunity to rationalize the taxation of income from business operations and investment but also as a vehicle for broader reform of their tax systems.
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Key words — income tax, tax reform, tax competition, progressivity

1. INTRODUCTION

In most developing countries income taxes, particularly personal income taxes, play only a limited role in financing public sector activities and have little effect on income distribution (Bird & Zolt, 2005). Developing countries have generally financed the limited expansion of public sector activities through increased revenues from value-added taxes (Martinez-Vazquez & Bird, 2010). In contrast to developed countries where personal tax revenues are often 3–4 times greater than corporate tax revenues, developing countries generally receive more revenue from corporate income taxes than personal income taxes, with the share from the personal income tax declining over the last 20 years (Martinez-Vazquez, Vulovic, & Liu, 2010). Adopting a different form of personal income tax—a dual income tax, a combination of a progressive tax on labor income and a lower flat rate tax on income from capital—may both improve existing personal income taxes in many developing countries and potentially to serve as an important platform toward more fundamental tax reform.

The paper is organized as follows. In Section 2 we first sketch the fiscal environment in developing countries and then outline several possible approaches to income tax reform. We address two of these approaches, the dual income tax and the flat tax, in more detail in the next two sections. Section 3 provides a brief account of the origin of the dual income tax in the very different economic, political, and tax environments of the Nordic countries in the late 1980s. [1] Section 4 summarizes recent experience with flat income taxes in several countries, mainly in Eastern Europe. Section 5 then discusses some of the critical issues that a country must resolve in designing and implementing a dual income tax. Such major tax reforms invariably carry economic and political risks, and the risk-gain calculus will differ from country to country. Nonetheless, we conclude in Section 6 that moving to a dual income tax seems likely to yield a more effective, equitable, and feasible income tax than the personal income tax regimes now found in most developing countries. Providing separate tax rates for labor and capital income allows countries more flexibility in addressing tax competition and a more coherent and rational system of taxation, while retaining explicitly progressive tax rates for labor income. In some cases, reforming the income tax may also serve as a catalyst leading to such other useful reforms as the reduction (or elimination) of tax incentives and the coordination of presumptive tax regimes for small and medium businesses with the rest of the tax system. [2]

2. TAXATION IN DEVELOPING COUNTRIES

The tax environment in developing countries differs substantially from that in developed countries. Tax burdens as a percentage of GDP are roughly 18% for developing countries, about half the levels of developed countries (Bahl & Bird, 2008). Spending patterns also differ from those in developed countries. As compared to developed countries, developing countries have much smaller government sectors and, in particular, smaller programs to alleviate poverty or to reduce inequality (Chu, Davoodi, & Gupta, 2000). Many developing countries not only require additional tax revenues to support government programs but also face challenges in maintaining existing revenues, particularly from income taxes, in the face of global tax competition.

Compared to developed countries, most developing countries rely more on consumption than income taxes, with VATs and excise taxes providing a substantial portion of tax revenues. Whether measured as a percentage of GDP or a percentage of overall tax revenue, personal income taxes play a much smaller role in developing countries than developed countries

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(Bird & Zolt, 2005). While the revenue from corporate income taxes varies substantially by region, corporate income taxes provide a major source of revenue in many countries. Generally, the poorer the country, the greater the proportion of total income tax revenues from corporate, relative to personal income taxes (Gordon & Li, 2009).

Almost all income tax regimes combine a personal income tax and a corporate income tax. The personal income tax generally applies to wage income, as well as different types of income from capital, such as dividends, interest, rents, royalties, and profits from sole proprietorships and partnerships. The corporate income tax usually applies only to profits from entities operating in corporate form. Many developing countries also have special presumptive tax regimes that replace income (and some other) taxes on micro and small businesses by imposing taxes, often fixed for a period of years, based on such factors as sales, number of employees, or size of establishment (Bird & Wallace, 2004). Many also have large shadow economies, which operate outside of the formal tax system, as well as significant agricultural sectors which they have not managed to tax effectively (Alm, Martinez-Vazquez, & Schneider, 2004; Alm, Martinez-Vazquez, & Wallace, 2004). Because these sectors constitute a much higher portion of total economic activity in developing countries than in developed countries, the tax base that tax authorities can potentially reach is relatively small in many developing countries. [3]

The sources of revenue from the personal income tax vary substantially among countries. While good comparative information about the revenue composition of personal income taxes in developing countries is not available, it is not uncommon for over 90% of personal income tax revenue in developing countries to come from wage withholding in the formal sector (Bird & Zolt, 2005). Personal income taxes in developing countries raise relatively small amounts of revenue either from profits from sole proprietorships or partnerships or from passive investment income such as dividends, interest, rents, and royalties. Some countries provide exemptions for certain types of passive income, but even when such income is taxable the tax administration often lacks the capacity to tax this income effectively. Those countries that succeed in collecting tax revenue from dividends and interest often do so by using final withholding regimes. On the whole, the small amount of personal income tax imposed on capital income in most developing countries underlines the desirability of rationalizing and improving capital income taxation (Tanzi & Zee, 2000).

Developing countries also collect little revenue from foreign passive investments held by residents. Some countries exempt all foreign source income, that is, income earned outside the country. Developing countries (such as the Philippines) that try to tax residents on their world-wide income have great difficulty taxing income from investments held by residents outside their country (Pomp, 1989). Nor does any country get much revenue from local passive investments held by non-resident investors. Even countries that apply final withholding taxes on such income often enter into tax treaties that trade away the right to collect income on passive investment held by foreign investors, presumably to attract more foreign investment (Keen & Simone 2004). [4] Final withholding tax rates are usually much lower than personal or corporate tax rates. As a result, interest paid by a business may be fully deductible under the personal or corporate income tax even when interest income is taxed at a much lower withholding rate (if at all) with the effect of reducing the net taxes imposed on income from other sources such as labor income.

Developing countries also vary greatly in the tax wedge (the difference between pre-tax and post-tax wages) applicable to labor income. Differences in tax rates under the personal income tax system partly explain such variations, but most of the difference is attributable to payroll or social security taxes imposed on workers and employers to fund unemployment, medical care, or pension benefits (World Bank, 2010). Taxes on wages and salaries (and associated benefits) are substantial in many central and eastern European and central Asian countries (Rutkowski, 2007) as well as in some Latin American countries (Perry & et al., 2007).

Corporate tax systems in developing countries similarly vary greatly in scope and design. Many developing countries receive most of their corporate tax revenues from a relatively small number of taxpayers, whereas other countries have a more diversified tax base. [5] While nominal tax rates tell only part of the story, as Table 1 shows, countries differ widely both as to the level of corporate income tax rates and the relationship of the corporate rate to personal income tax rates. While some regional convergence does exist, there is no easy explanation either for the variation in the level of tax rates or the

Table 1. *Personal and corporate income tax rates in selected developing countries*

	Personal income tax (2008)	Corporate income tax (2009)	Difference
Senegal	50	25	25
Croatia	45	20	25
Chile	40	17	23
Hungary	38	16	22
Poland	40	19	21
China	45	25	20
Slovenia	41	21	20
Vietnam	40	25	15
Turkey	35	20	15
Uzbekistan	25	10	15
Morocco	42	30	12
South Africa	40	28	12
Cyprus	25	15	10
Georgia	25	15	10
Indonesia	35	28	7
Belarus	30	24	6
Latvia	20	15	5
Serbia	15	10	5
Malaysia	28	25	3
Mexico	30	28	2
Hong Kong	17	16.5	0.5
Argentina	35	35	0
Venezuela	34	34	0
Guatemala	31	31	0
Peru	30	30	0
Tanzania	30	30	0
El Salvador	25	25	0
Estonia	21	21	0
Egypt	20	20	0
Slovak Republic	19	19	0
Romania	16	16	0
Zambia	35	40	−5
Czech Republic	15	20	−5
Russia	13	20	−7
Jordan	25	35	−10
Kazakhstan	10	20	−10
Pakistan	20	35	−15
Angola	15	35	−20

Sources: Ernst (2009), Ernst (2009a).

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