

Reforming Personal Income Tax

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Introduction

Many OECD countries have reformed their personal income tax system over the last two decades. Yet no clear consensus has emerged on what is the ideal personal income tax.

These reforms have tried to create a competitive fiscal environment, which encourages investment, risk taking and entrepreneurship and provides increased work incentives. At the same time, fairness and simplicity have become the byword of reformers. Fairness requires that taxpayers in similar circumstances pay similar amounts of tax and that the tax burden is appropriately shared. Simplicity requires that paying your taxes becomes as painless as possible and that the costs of collecting taxes are kept at a minimum.

Almost all of these tax reforms reduced the tax rates and broadened the tax base. Many countries have moved away from comprehensive personal income tax systems, which tax all or most wage and capital income according to the same progressive rate schedule. A number of alternative tax systems have been introduced.

The dual income tax system established in the early 1990s in the Scandinavian countries taxes personal capital income at low and proportional rates while labour income continues to be taxed at high and progressive rates.

More recently, flat tax proposals have been put high on the political agenda. Flat tax reforms mainly consist of two elements: reducing the tax rate schedule to a single rate and eliminating special tax reliefs, with the possible exception of a basic allowance.

This *Policy Brief* looks at the recent trends in the taxation of personal income in OECD countries and evaluates the different types of personal income tax reforms. ■

What are the main tax reform trends?

There are large differences between OECD countries in the share of personal income tax as a percentage of both total tax revenue and GDP (see Figure 1). In 2003, personal income tax as a percentage of total tax revenue varied from almost 11% in the Slovak Republic to 53% in Denmark. As a percentage of GDP, it varied from 3.2% in Korea to over 25% in Denmark.

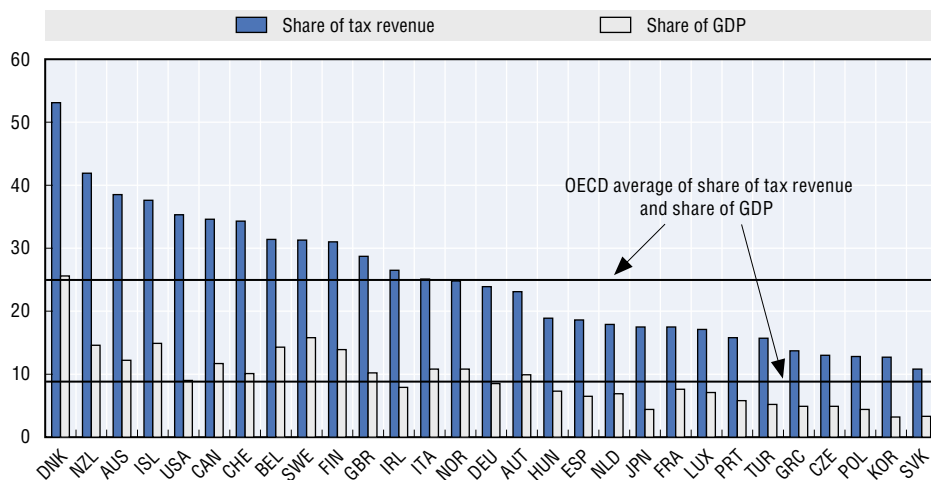
There are substantial differences between OECD countries in the level of personal income taxes and in the reliance on social security contributions (see Figure 2). The tax wedges measure the difference between labour costs to the employer and the net take-home pay of the employee. Figure 2 also shows the parts of the wedges that are due to personal income taxes plus employee social security contributions and that are due to personal income taxes alone.

Between 2000 and 2005, personal income taxes on labour have, on average, been reduced (see Table 1). For a single person earning 67% of full-time average production worker (APW) earnings, the rate has been reduced by 0.8 percentage points. They have been reduced by 0.6 and 0.7 percentage points at 100% and 167% of APW earnings respectively. The total tax wedge on labour is significantly higher when social security contributions are included.

The unweighted OECD average of the top marginal income tax rates on labour income (see Figure 3) has decreased from 47% in 2000 to 43.3% in 2005. A reduction is also observed with respect to the top marginal tax rates on dividend income. This is part of a general trend of reducing tax rates at all income levels. It also suggests a reduction in the use of high marginal rates for top-income earners as a vehicle for income redistribution.

As part of a trend towards “flatter taxes”, many countries have reduced the number of tax brackets. This trend – also caused by the reduction in the top marginal income tax rates – has continued after 2000. The number of brackets in the personal income tax system in 2005 varies from just one rate in the Slovak Republic to 16 in Luxembourg. ■

FIGURE 1. PERSONAL INCOME TAX IN OECD COUNTRIES AS A SHARE OF TOTAL REVENUE AND OF GDP (2003)



Source: OECD, Revenue Statistics 1965-2004.

Why reform personal income taxes?

Governments find themselves squeezed by pressures to maintain or to increase their expenditures on the one hand and the need to make their tax systems more competitive on the other hand. The ageing of the population, high levels of unemployment, the need to replace physical infrastructures and the remaining government debt all increase the pressure on government expenditures. Yet at the same time, increased international mobility has increased tax-competition and put a downward pressure on tax rates.

Efficient tax systems seek to minimize tax induced distortions. Efficiency is achieved by broad tax bases and small differences in tax rates that can be applied to different bases.

The redistribution of income and wealth through the tax system is a policy objective in all OECD countries. But over the last decade, it is fair to say that greater attention has been given to achieving a fair tax system, one which achieves horizontal equity, i.e. taxpayers in an equal situation are taxed in an equal manner.

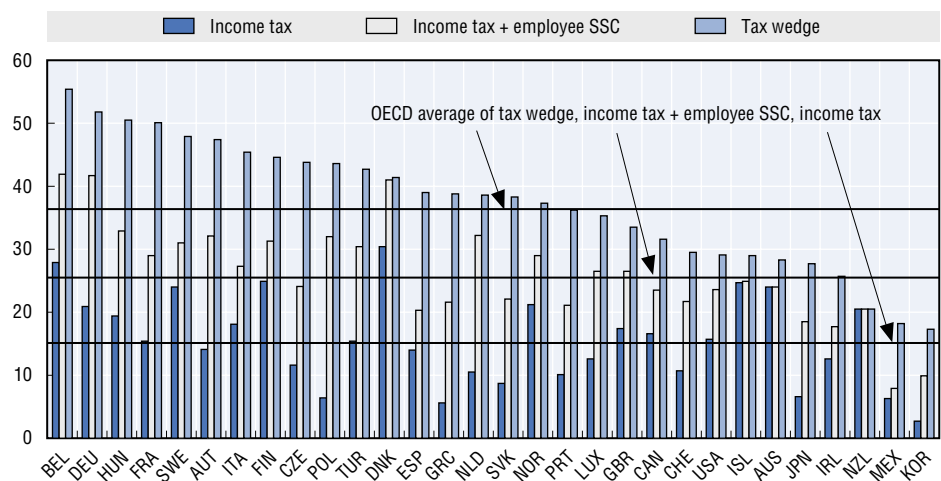
Another significant part of the political debate on personal income tax reform is the need to simplify the tax system. Simple tax rules often allow for lower tax rates. Governments might also increase overall tax compliance by simplifying their tax system. ■

How to tax personal income?

There are 3 approaches to taxing personal income:

- The comprehensive income tax system taxes all or most wage and capital income less deductions according to the same (usually) progressive rate schedule. This type of tax system usually has significant tax allowances and tax exemptions, whose value to the taxpayers increases with income.

FIGURE 2. INCOME TAX AND SOCIAL SECURITY CONTRIBUTIONS IN OECD COUNTRIES¹ (2005)



1. As % of labour costs – gross wage earnings of employees plus employer social security contributions – for single individuals at 100% of average wage.

Source: OECD, *Taxing Wages 2004-2005*.

- The dual income tax system levies a proportional tax rate on all net income (capital, wage and pension income less deductions) combined with progressive rates on gross labour and pension income. Labour income is then taxed at higher rates than capital income, and the value of the tax allowances is independent of the income level.
- The flat tax system levies a proportional (flat) tax rate on all net income (capital income, labour income, and other income minus all deductions). Wage and capital income are then taxed equally and the value of the tax allowances is independent of the income level. ■

What are the main characteristics of these tax systems?

Comprehensive income tax systems are based on the principles of horizontal and vertical equity: taxpayers with the same level of income are taxed equally and taxpayers with higher incomes are taxed more heavily. Moreover, comprehensive income tax systems make it more difficult to avoid taxes through income shifting – in many countries it is profitable to transform higher-taxed labour income into lower-taxed capital income. However, implementing a comprehensive tax system implies fairly high compliance and administrative costs. In addition, progressive income tax systems discriminate against variable income. This may for example discourage seasonal work and reduce investment in human capital and the demand for risky assets.

In practice, no OECD country has fully implemented a comprehensive personal income tax system. All countries have special tax treatment for certain types of income (fringe benefits, owner-occupied housing, capital gains, pensions...) and many countries levy social security contributions only on certain types of income (mainly labour income). This lack of neutrality, in turn, increases the compliance and administrative costs, reduces tax compliance and tax revenues and impairs the efficiency and equity of the tax system.

Dual personal income tax systems achieve horizontal equity in the taxation of capital income on the one hand and in the taxation of labour income on the other hand. The lower tax rate on capital income also reduces the incentives for capital exports and tax avoidance and evasion. The focus on redistribution and the need to raise a sufficient amount of tax revenue explains the progressive tax rates on labour income. However, taxpayers with a different mix of capital and labour income are taxed differently. Moreover, income shifting between higher-taxed labour income and lower-taxed capital income remains attractive.

TABLE 1. INCOME TAXES AND SOCIAL SECURITY CONTRIBUTIONS ON AVERAGE IN OECD (2000 VS. 2005)

	67% of APW		100% of APW		167% of APW	
	2000	2005	2000	2005	2000	2005
Income tax	12.2	11.4	16.2	15.6	23.0	22.3
Income tax + employee SSC	22.5	22.1	26.6	26.2	32.4	32.1
Tax wedge	34.4	33.7	37.9	37.3	42.4	42.1

Source: OECD, *Taxing Wages* 2004-2005.

These income-shifting problems are not encountered under a flat personal income tax system. The introduction of a flat tax is often combined with a significant reduction in tax allowances and credits. This base broadening renders the tax system more simple and easier to administer, and should increase efficiency. However, flat personal income tax systems limit the scope for a fair sharing of the tax burden. ■

**Flat taxes:
the way forward?**

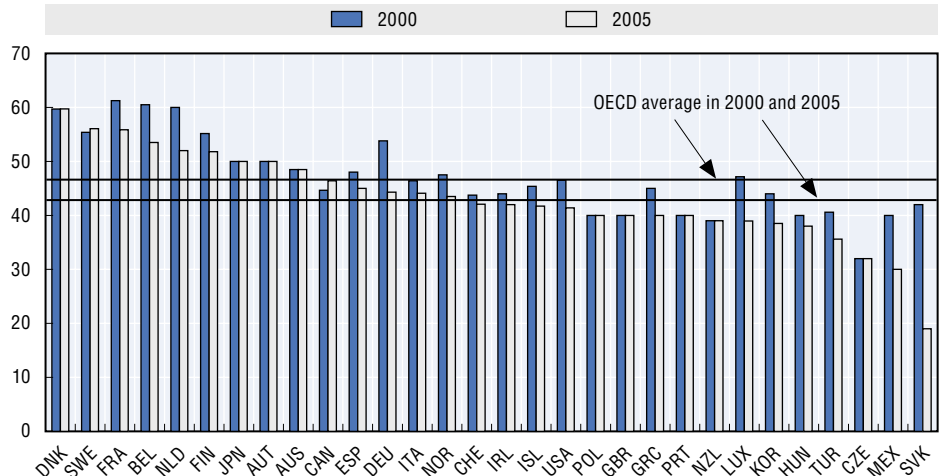
The first major economy to introduce a flat tax was Russia, in January 2001. This reform broadened the personal income tax base and introduced a flat personal income tax rate of 13% for income in excess of a basic allowance. Tax administration and enforcement rules were reformed as well.

Prior to the reform, most Russian taxpayers faced an overall marginal rate of personal income tax and social security contributions of 37.1%. After the reform, it was 35.8%. Taxpayers with higher labour income realized a larger reduction.

Revenue from the personal income tax increased by about 20% relative to GDP between 2000 and 2001. Revenue increased by about 46% in nominal terms and by about 25% in real terms, although it is unclear how much of the revenue increase can be attributed to the reform.

The Russian flat tax reform has made the tax system simpler and more transparent. The broadening of the tax base and especially the replacement of the progressive tax rate schedule by a single 13% tax rate made it easier to comply with the tax code. Fairness of the tax system has also been improved by the stronger tax enforcement and by the reform of the Russian tax administration. In fact, it appears that these administrative reforms have had a more fundamental impact than the changes in the income tax rates (Ivanova, Keen and Klemm (2005)).

FIGURE 3. TOP STATUTORY TAX RATES ON WAGE INCOME¹ (2000 AND 2005)



1. The statutory personal income tax rates on wage income applicable at the highest income threshold for single individuals.

Source: OECD Taxing Wages calculations.

The flat tax reform in the Slovak Republic of 1 January 2004, introduced a flat personal income tax rate of 19% on corporate and personal income. The tax reform broadened the tax base by eliminating almost all tax reliefs, but increased the basic allowance. At the same time, the Slovak government reduced social assistance benefits and shifted the tax burden from direct to indirect taxation. They continue to levy high health and social security contributions.

The tax reform has made the tax system simpler and more transparent. It has also strengthened the incentives for investment and for entrepreneurial activity, reduced the distortions in the allocation of capital and increased efficiency due to a further broadening of the tax base. However, the positive effects of the flat rate on labour income should not be exaggerated as the relevance of personal income tax in the Slovak Republic remains low, especially in light of high social security contributions that can be deducted from the personal income tax base and the relatively high VAT. ■

What about dual income taxes?

The dual income tax system can best be understood by looking at Norway. Norway taxes all personal income at a flat personal income tax rate of 28%. The same rate is used for corporate income. In addition to the flat rate, a progressive surtax is levied on gross income from wages and pensions above a certain threshold.

Double taxation of distributed profits was prevented through a full imputation system. Double taxation of retained profits was prevented through the use of the so-called RISK scheme.

In order to ensure an equal tax treatment of wage earners and the self-employed, the dual income tax system splits the income of the self-employed into a labour income component as a reward for work effort and a capital income component, which is the return to the savings invested in the proprietorship. The part considered as labour income is taxed according to the progressive rate schedule. The part considered as capital income is taxed at the flat rate. This approach is also used to avoid active owners of closely held corporations transforming their highly-taxed wages into lower-taxed capital income.

There are two main problems with the dual income tax system. First, dividends and capital gains on foreign shares were taxed more heavily than dividends and capital gains on shares in Norwegian companies. Second, the large difference in top marginal tax rates on labour and capital income gave taxpayers an incentive to define their income as capital rather than as labour income.

As from January 2006, the Norwegian government introduced a higher shareholder income tax on realized income of shares above a “normal” rate of return. This shareholder income tax will be levied on the shares of Norwegian and foreign firms owned by resident taxpayers in Norway. At the same time, the top marginal personal income tax rate has declined. Because these adjustments significantly reduce the rate differential on the margin, incentives to convert labour income to capital income are reduced. ■

Where do we go from here?

Many OECD countries have *semi-comprehensive* income tax systems. These tax systems open up tax-arbitrage possibilities – individuals making use of differences in tax rules and rates and of tax exemptions and allowances. These problems have led to tax policies that focused on broadening the tax base and lowering tax rates.

No OECD country has attempted to introduce a pure system: comprehensive, dual or flat. Some countries have introduced *semi-dual* income taxation, in the sense that some personal capital income is taxed at lower rates than wage income. Pure dual and flat personal income tax systems are options for further tax reform. Which tax system is preferred remains an open question and the answer is likely to vary between countries.

Dual income tax systems are not without their problems either. Due to the large difference in top marginal tax rates on labour and capital income, taxpayers face an incentive to have their income characterised as capital income rather than as labour income. The Norwegian government has attempted to tackle this problem, but it is too early to assess the overall impact of this recent tax reform.

Neither Russia nor the Slovak Republic have implemented a genuine “flat” tax system, which would tax all types of income once – thereby resolving all types of distortions – at a flat rate. Both countries continue to levy social security contributions separately. The use of social security contributions means that there continue to be gains from income shifting between capital and labour income, even under a flat personal income tax system. If social security contributions do not confer an actuarially fair entitlement to a possibly contingent future social benefit, flat tax systems turn into (semi-) dual income tax systems with proportional instead of progressive taxation of labour income.

Given the government’s revenue needs, having a flat tax on capital and labour income might require a rather high tax rate, which might raise problems because of the international mobility of the tax bases. On the other hand, implementing a rather low flat tax rate would undermine the benefit system in many OECD countries and would undermine income redistribution. ■

For further information

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For further reading

- OECD (2006), **Fundamental Reform of Personal Income Tax**, OECD Tax Policy Studies, No. 15, forthcoming.
- OECD (2006), **Taxing Wages 2004-2005**, ISBN: 92-64-02202-3, 280 p., € 95.
- OECD (2005), **Revenue Statistics 1965-2004**, 2005, ISBN: 92-64-01284-2, 336 p., € 90.
- Ivanova, Keen and Klemm (2005), The Russian "Flat Tax" Reform, *Economic Policy*, Vol. 20, No. 43.

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