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## **Dual Income Taxation: A Potentially Promising Approach to Tax Reform in Developing Countries**

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## I. INTRODUCTION

Businesses often seek to find new applications for existing products. TNT was originally designed as a yellow dye. Listerine, a popular mouthwash, was used as an antiseptic for surgery. Viagra was initially designed to treat hypertension. The dual income tax, a combination of a progressive tax on labor income and a lower flat rate tax on income from capital, was adopted in the Nordic countries to address a set of tax challenges that arose in the late 1980s.<sup>1</sup> Although developing countries face much different economic, political, and tax environments than the Nordic countries, the dual income tax may be the right solution to the different set of challenges that exists in developing countries.

Transplanting legal regimes, like using prescription drugs for purposes other than those for which they were designed, may result in undesirable and unintended consequences.<sup>2</sup> Nonetheless, we contend that the dual income taxation may be an effective tool to save rather than bury effective income taxation in developing countries. Explicitly providing separate tax regimes for income from capital and income from labor may also provide an opportunity to improve substantially the tax regimes of many developing countries by facilitating broader tax reforms in such areas as integrating personal income taxes and payroll or social security taxes, coordinating presumptive tax regimes for small business with the corporate income tax systems, and taxation of portfolio income held by held by residents and non-residents.

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<sup>1</sup> See discussion in Section II.A, the Nordic countries faced several major challenges that led to adopting dual income tax regimes: (i) the high individual tax rates on dividend and interest encouraged domestic investors to shift portfolio investments to off-shore tax havens; (ii) relatively high rates of inflation resulted in very high effective rates on income from capital; (iii) the deductibility of interest and other expenses related to income from capital often resulted in significant negative effective tax rates on capital (thus, reducing tax revenue from labor income); and (iv) high unemployment provided political support for reducing taxes to encourage economic activity .

<sup>2</sup> Where and how a particular solution is applied matters. The drug thalidomide was banned several decades ago owing to its severe effects on fetal development when taken by pregnant women; nonetheless, the same drug is now approved as one of the most effective treatments known for multiple myeloma and has also proved useful in the treatment of leprosy.

The dual income tax approach rejects the long-held ideal of a global, progressive comprehensive income tax. To some, this may seem a step in the wrong direction. For decades, tax policy advisors in developing countries, like tax academics in general, have focused on a global progressive personal income tax (a “comprehensive income tax”) as the essential keystone to any modern tax system.<sup>3</sup> Although there have always been those who questioned the conventional wisdom,<sup>4</sup> the comprehensive income tax was long accepted as the ideal towards which all good income tax systems should strive. Distinguished academics such as Stanley Surrey and Richard Musgrave spread the word to developing countries to help modernize and improve the design and implementation of tax systems.<sup>5</sup>

In reality, however, the personal income tax system in most developing countries (as well as most developed countries) is neither global nor very progressive.<sup>6</sup> The so-called comprehensive income tax system is often little more than a set of mismatched schedular levies. Developing countries face serious challenges in improving the taxation of income, whether income from labor, capital, or both combined. As we observed in a prior article, because of these challenges personal income taxes play a very limited role in developing countries.<sup>7</sup> Most developing countries subject income from capital to relatively light effective tax burdens under the personal income tax system, whether through policy design or poor tax administration or both. However, countries often achieve this low tax burden in so cumbersome and inefficient any way as to reap both the costs of taxing capital (economic distortions, in some cases greater than the actual tax collected) and also the costs of failing to do so (inequity, as well as administrative problems from tax arbitrage). They fail to achieve the potential gains of “untaxing” capital under personal income tax systems in the forms of more efficient allocation of the country’s scarce resources, increased savings and investment, and lower administrative and compliance costs.

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<sup>3</sup> Tax systems are considered global if they include income from all sources in a common tax base. Tax systems are progressive if higher marginal income tax rates apply to greater amounts of taxable income.

<sup>4</sup> For example, Bittker (1967) [A “Comprehensive Tax Base” as a Goal of Income Tax Reform]

<sup>5</sup> For example, see Surrey and Oldman (1961) on Argentina and Musgrave and Gillis (1971) on Colombia and Musgrave (1981) on Bolivia.

<sup>6</sup> In all countries, a large portion of private savings is tax-favored. Low or no taxes apply to savings in owner-occupied housing, pension and other retirement savings, and retained corporate profits.

<sup>7</sup> Bird and Zolt (2005).

Developing countries face equally or even more serious challenges in implementing corporate income tax systems. Some corporate tax systems combine relatively high nominal tax rates with a porous tax base, again resulting from policy design and sometimes, ineffective (and perhaps corrupt) tax administration. Tax holidays, tax-free zones, and other tax incentives erode the potential corporate income tax base and may, sometimes deliberately, create advantages for foreign over domestic firms. While all countries face difficulties in taxing the agricultural sector and small businesses, developing countries face greater challenges both because of the lack of administrative capacity to tax effectively these sectors and because the costs of taxes and other forms of government regulation may outweigh the benefits from operating in a formal economy.

One alternative to improve tax regimes in developing countries is to abandon taxing income from capital and move to a personal consumption tax of the types that have been proposed over the last few decades.<sup>8</sup> We have nothing to add here to the discussion on the relative superiority of the income versus consumption taxes or the transitional challenges that such a move would entail. Nonetheless, we think there are excellent reasons for developing countries to retain both personal and corporate income taxes. Although the personal income tax in most developing countries is limited in its ability to redistribute income, it can and should play an important role in both generating revenues and by helping to establish a more politically cohesive and stable state.<sup>9</sup> Despite the many qualifications noted in our earlier article, the income tax and, in particular, the personal income tax is probably the only significantly progressive element found in most developing country tax systems.<sup>10</sup> In addition, the corporate income tax plays a much greater role in raising revenue in developing countries than developed countries and, in particular, provides a successful mechanism for capturing at least some location-specific rents.<sup>11</sup>

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<sup>8</sup> For a useful review of the various proposals that have been made in the US, see McLure and Zodrow (2007).

<sup>9</sup> The important political dimension of taxation in developing countries is emphasized in Brautigam, Fjeldstad and Moore (2008).

<sup>10</sup> Chu, Davoodi, and Gupta (2004).

<sup>11</sup> Sorenson (2006); Ganghof (2001).

Previous scholarship on the dual income tax has focused almost exclusively on developed countries.<sup>12</sup> This article extends examination of the dual income tax approach to the developing country context. Section II begins with a brief review of the Nordic experience with dual income tax regimes. We examine the competing considerations facing policy makers in the Nordic countries and highlight the factors that led those countries to bifurcate the tax treatment of labor and capital income. We then review several parallel, but not identical, reforms that have been proposed or implemented in other developed countries.

Section III reviews the different ways in which developing countries might implement a dual income tax regime and examines the possible advantages and disadvantages of the different approaches. Substantial differences exist in the political, economic and tax environment both between and among developed and developing countries. These differences influence both the form and desirability of separating the taxation of labor and capital income.

Section IV compares the dual income tax with the flat tax proposals of the stripe that have been adopted in several Eastern European countries and the countries of the former Soviet Union. Here, we suggest that the dual income tax, properly conceived, can combine many of the advantages of flat tax regimes with many of the traditional virtues of a personal income tax system that is at least mildly progressive.

We conclude by noting that major tax policy or tax administration reforms carry economic and political risks, and the risk-gain calculus will differ from country to country. We also believe that adopting some form of dual income taxation may facilitate broader tax reforms in developing countries. These reforms include coordinating presumptive tax regimes for small and medium businesses with the corporate tax system, integrating the payroll or social security tax systems with the personal income tax systems, and the rationalizing the existing tax regimes for taxing the portfolio income of domestic and foreign investors.

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<sup>12</sup> The main exceptions are Boadway (2004) (on developing countries in general) and Barrioux and Rocha (2007) (on Uruguay).

## II. DUAL INCOME TAX SYSTEMS IN THE NORDIC COUNTRIES

### A. Tax Challenges Facing Nordic Countries

Denmark, Finland, Norway and Sweden were among the first countries explicitly to reject the comprehensive income tax model and adopt separate tax regimes for taxing income from labor and income from capital.<sup>13</sup> Several factors contributed to the decisions to adopt dual income tax regimes. First, the Nordic countries sought to slow down the flow of portfolio investment outside their countries. Top marginal personal income tax rates in the mid-1980s ranged from 66% in Norway to 87% in Sweden.<sup>14</sup> The globalization of capital markets made it easier for a large class of individual investors to establish and maintain investment and bank accounts outside their home country. Given the high tax rates that individuals in the Nordic countries were facing on portfolio income, strong incentives existed for domestic investors to move their investments offshore and seek to avoid domestic taxation.

Second, relatively high inflation rates resulted in very high effective tax rates on capital income. Even at modest rates of inflation, subjecting nominal interest income to tax rates over 50% results in very high effective tax rates on real interest income. Tax systems in most countries do not provide for adjustments for inflation.<sup>15</sup> The combination of high tax rates, relatively effective tax administration, and no inflation adjustments made the problems more acute in the Nordic countries. Applying a low flat rate to capital income provides a rough adjustment for inflation.<sup>16</sup>

Third, tax regimes in the Nordic countries provided substantial tax preferences for capital investments. As in other countries, this often resulted in the current deductibility of many expenses while tax on the income associated with the expenses was deferred. The largest component was full deductibility of interest on debt incurred to finance tax-favored assets. The resulting negative effective tax rate on capital income allowed taxpayers to reduce their tax liability

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<sup>13</sup>The dual income tax first appeared in the Danish 1985 tax reform and then was adopted in different forms in Sweden (1991), Norway (1992), and Finland (1993).

<sup>14</sup> For example, Sweden's top marginal rate under the personal income tax system was 87% in 1979, 65% in 1990, and 51% in 1991. Larson (2006).

<sup>15</sup> See generally, Thuronyi (1998). [Adjusting Taxes for Inflation, Tax Law Design and Drafting].

<sup>16</sup> Sorenson (2006).

on labor income.<sup>17</sup> Providing separate tax regimes for income from labor and capital stopped the erosion of the tax base for labor income.<sup>18</sup> Although the dual income tax reforms reduced the tax rates on income from capital, the increase in tax revenue from labor income more than compensated for reduced tax revenue from income from capital.<sup>19</sup>

Finally, the economies in the Nordic countries were struggling during this time period. In particular, substantial concerns existed about high levels of unemployment. While Nordic levels of unemployment were low by international standards, the levels of unemployment in the late 1980s and early 1990s were high by historical standards (and would continue to increase). These concerns helped provide political support for reducing the tax burden on income from capital as a means to increase economic activity.<sup>20</sup>

It is useful to consider these factors in the context of the Nordic countries' long tradition of large social programs and the high taxes that are necessary to support them. Added to the challenges facing these countries, tax reforms throughout the world in the mid-to-late 1980s resulted in significant tax rate cuts for individual and corporate income taxes. While the Nordic countries increased taxes on consumption during this time period, they still needed substantial revenues from income taxes to fund government operations.<sup>21</sup> The Nordic countries essentially faced two choices in reforming their income tax systems: either reduce tax rates for all income and generate insufficient income tax revenue to support social programs; or bifurcate the tax regime and apply a lower rate to income from capital while maintaining the high progressive tax rates on labor income.

The tax design challenges facing the Nordic countries can be viewed in a larger framework that highlights how global pressures can influence domestic tax

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<sup>17</sup> See Sorenson (1988, 2006).

<sup>18</sup> The need to protect the labor tax base led the U.S. to adopt the passive activity loss rules that prevented taxpayers from sheltering labor income from losses associate with passive investments. Section 469 of the Internal Revenue Code (adopted as part of the Tax Reform Act of 1986).

<sup>19</sup> Sorenson contends that for several years before introducing dual income tax regimes there was likely net negative tax revenue from personal income tax on capital income in Norway and Sweden. Sorenson (1998). For similar results in other countries, see Gordon and Slemrod (1988)(United States) and Becker and Fuest (2003) (Germany).

<sup>20</sup> Cnossen (2004); Genser and Rutter (2008).

<sup>21</sup> For information on changes in the reliance on consumption taxes in the Nordic countries, see OECD (2007) [Revenue Statistics 1965-2006]. For an interesting detailed appraisal of the historic evolution of the Nordic tax financing model, see Lindert (2003).

regimes. In a series of working papers and articles, Stephan Ganghof puts forth a taxonomy that nicely demonstrates the competing considerations a country may face in designing an income tax system.<sup>22</sup> Ganghof begins with three domestic policy goals that governments may consider in designing an income tax regime. The first goal is *wage tax progressivity*.<sup>23</sup> This goal addresses concerns of vertical equity by requiring high-income wage earners to pay a higher proportion of their income in tax. The second goal is *comprehensiveness*, which requires equal treatment of income from capital and income from labor. This addresses concern of horizontal equity, and together with the first goal, results in taxing individuals in accordance with “ability to pay” principles. The third goal is *symmetry*, which exists when all types of capital income are subject to the same tax regime.

In a closed economy, the comprehensive income tax can satisfy these three objectives. At least in its ideal form, the comprehensive income tax achieves all three goals by taxing income from all sources equally, in a progressive manner according to a taxpayer’s ability to pay, such that a taxpayer faces the same tax regime on different types of capital income. With the competitive pressures in an open economy, however, something has to give. With *competitiveness* added to the three tax domestic tax policy goals, governments may no longer be able to satisfy all goals, particularly if, as the evidence suggests is true, the cross-border mobility of capital varies both between types of capital and types of countries (Devereux 2008). In Ganghof terminology, governments face an income tax *quadrilemma*: the choices are to sacrifice progressivity, sacrifice comprehensiveness, sacrifice symmetry, or sacrifice competitiveness.

Depending on economic and political factors, countries face different considerations in determining which objective to sacrifice. The Nordic countries sacrificed comprehensiveness by providing different treatment for capital and labor income. Other countries chose to sacrifice progressivity, symmetry, or competitiveness.<sup>24</sup> Because of the different tax environments facing the Nordic countries and developing countries, many of the considerations that prompted

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<sup>22</sup> Ganghof (2001; 2004; 2006).

<sup>23</sup> A tax system with wage tax progressivity and comprehensive would apply progressive tax rates on both labor and capital income. As Graetz (2008) notes, it is not clear why labor income should be subject to progressive tax rates and income from capital should be taxed at flat rates.

<sup>24</sup> Denmark also chose to sacrifice symmetry by imposing differential tax rates on capital income. Ganghof 15. New Zealand chose instead to cut all income tax rates, thus sacrificing progressivity. Australia elected instead to cut only the corporate income tax rate, sacrificing symmetry. Ganghof and Eccleston (2006). In contrast, Germany, until its most recent reforms, sacrificed competitiveness in order to retain the other three objectives.

Nordic countries to sacrifice comprehensiveness may not apply in developing countries. However, developing countries may nonetheless be able to improve their tax system substantially by sacrificing comprehensiveness and adopting separate tax regimes for capital and labor income.

#### B. Design of Dual Income Tax Systems—Variation among countries and over time

The dual income tax systems in Nordic countries share much in common. They provide for a progressive income tax rate schedule applicable to labor income<sup>25</sup> and a flat tax rate on capital income. In the initial dual income tax reforms, only Norway aligned the personal tax rate on capital income with the lowest positive tax rate on labor income; in Finland, the rate on capital income was slightly higher than the lowest positive labor tax rate and in Sweden the personal income tax rate on capital income was slightly lower than the lowest positive labor tax rate. In the so-called “pure” version of the dual income tax, the tax rate on capital income is also aligned with the corporate tax rate.<sup>26</sup>

[add Table 1 here]

Income from capital taxable under the dual income tax system generally includes business profits, dividends, interest, rents and some types of royalties. Policy makers could also choose to expand the scope of dual income tax systems to include income from capital such items as imputed rent on owner-occupied housing and returns on pension savings (as well as other forms of current tax-favored savings).<sup>27</sup>

The Nordic countries also differed in their degree of integration of the corporate and personal income tax systems. Norway provided the greatest degree of integration. Until 2005, Norway eliminated the double taxation of equity income by providing an imputation system for distributed dividends and allowed

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<sup>25</sup> Good descriptions of the Nordic dual income tax systems are set forth in Genser and Reutter (2007) and Sorenson (2007). The dual income tax in Finland taxed labor income at tax rates ranging from 27.4 to 50.9%; Norway provided for labor income rates ranging from 28 to 49%; and Sweden provided for labor income rates ranging from 31.5 to 56.5%.

<sup>26</sup> Sorenson (2005). Although a really “pure” version would presumably also provide for full integration of personal and corporate level taxes to avoid double taxation of corporate income this is not a necessary consequence of aligning the capital income and corporate income tax rates.

<sup>27</sup> Boadway (2004). More robust forms of dual income tax could include returns on consumer durables and returns to human capital accumulation.

shareholder to increase their basis of their corporate shares by their pro-rata amount of the retained profits that was subject to corporate tax.<sup>28</sup>

### C. Arbitrage opportunities

The move from a comprehensive income tax to a dual income tax regime presents tax planning (or tax evasion) opportunities. With lower tax rates applicable to income from capital, strong incentives exist to characterize income from labor as capital income. This is hardly news. Incentives to convert labor income into income from capital exist in many tax systems, especially those that provide for favorable tax treatment for capital gains or subject labor income to social security taxes that substantially increase the marginal effective tax rates for labor income, but not the tax rates for income from capital.

The major challenge in the Nordic dual tax systems is to limit taxpayers from converting their labor income from self-employment (from sole proprietorships or partnerships) or wages of owner-employees of closely-held corporations into income from capital. The dual income tax regimes of the four countries have tried different approaches to prevent taxpayers from transforming labor income into capital income.

One approach provides for an imputed return to the firm's business assets by multiplying the value of the assets by an assumed rate of return on capital (interest rate on government debt, plus some risk premium).<sup>29</sup> The asset base could be the firm's gross assets, in which case the firm's financial liabilities are not deducted from the asset base. Alternatively, countries could determine the imputed return of the net assets and thus provide for a deduction for business liabilities (as well as adjusting net profits for interest deductions).<sup>30</sup> Profits in excess of this imputed

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<sup>28</sup> In the Norwegian tax system this was known by its Norwegian acronym RISK. A similar version was proposed by the U.S. Treasury Department as a deemed dividend reinvestment plan (DRIP) system. U.S. Treasury (1992).

<sup>29</sup> For example, the Norwegian approach uses the interest rate on 5 year governments bonds plus a risk premium of 4%. If the imputed rate of return equals the interest on business debt, it will not matter whether the calculation is based on gross assets or net assets (excluding liabilities). If the rates differ, taxpayers under a net asset regime may have incentives to adjust their borrowings to maximize the amount of income from capital. Sorensen (2005).

<sup>30</sup> Sorenson notes that Norway adopted a version of the gross asset approach, Finland and Sweden adopted versions of the net asset approach, and Denmark adopted a regime that allows taxpayers to choose between variations of the two approaches. Sorenson (2005).

return are deemed to be returns from labor and are subject to taxation as labor income whether or not distributed to the owner.<sup>31</sup>

Taxpayers may also seek to avoid higher tax rates on labor income in those cases where owner-employees own a large percentage of the shares of closely-held corporations. Such owner-employees will seek to minimize their wage compensation and then extract returns in the form of lower taxed dividends and capital gains. To limit this tax strategy, countries can tax normal returns to capital as income from capital, but then tax excess returns to capital under the progressive tax rates applicable to labor income or alternatively, by requiring closely-held businesses to be taxed as flow-through entities, regardless of legal form of organization.<sup>32</sup>

The rules designed to prevent re-characterization of the income generated their own set of distortions. For example, the regime that determines capital income with reference to the amount of capital invested will encourage taxpayers to stuff significant assets into their corporations. Those rules that seek to apply only to closely-held corporations with a percentage of active owners will encourage taxpayers to add passive owners to avoid application of these rules.

In sum, the larger the spreads between the flat tax rate applicable to capital income, the corporate tax rates, and the progressive tax rates applicable to labor income, the greater the arbitrage opportunities. While there are significant challenges in the Nordic countries (as well as other Western European countries) to preventing taxpayers from disguising labor income as capital income, different considerations likely apply in developing countries.<sup>33</sup>

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<sup>31</sup> A variation of this approach uses the costs of shares as the base for computing the return to capital and then treats any excess returns as labor income.

<sup>32</sup> Sorenson notes that the mandatory income splitting features of the Norwegian tax system worked relatively well for self-employed taxpayers, but not so well for “active” owners of small corporations. These employee-shareholders could avoid the mandatory income-splitting rules by increasing the percentage of shares owned by “passive” investors to avoid treating part of the income they received from the corporation as income from labor. Beginning in 2006, active owners of small business are taxed at the lower capital income tax rates on the imputed normal rate of return on the value of their shareholdings, but at the higher effective tax rate applicable to labor income for amounts of realized income (dividends and capital gains) in excess of the normal rate of return. Sorenson (2006), 38-40.

<sup>33</sup> See discussion in Section \_\_\_.

#### D. Reforms outside the Nordic Countries

Several other countries have considered or adopted different types of dual income tax systems.<sup>34</sup> Even under the purported comprehensive income tax, in all countries tax regimes provide for different effective taxes on different types of income.<sup>35</sup> Thus, elements of the Nordic dual income tax regime can be found in existing and proposed tax systems of other countries.

For example, several countries have adopted final withholding taxes on interest and dividends at rates below the top marginal rates under the personal income tax system. In the European Union, such countries include Austria, Belgium, Italy, Portugal, the Czech Republic, Lithuania, and Poland.<sup>36</sup>

In 1992, the U.S. Treasury proposed a version of a dual income tax as part of its study of integrating the personal and corporate income tax system.<sup>37</sup> This proposal is known as the Comprehensive Business Income Tax (“CBIT”).<sup>38</sup> A large literature has examined how the “classical” corporate income tax system distorts choices between operating in non-corporate and corporate form, choosing between debt finance and equity finance, and retaining rather than distributing corporate profits.<sup>39</sup> The Treasury report set forth various proposals to reduce distortions and rationalize the treatment of business income.

Three fundamental objectives influenced discussions within the Treasury working group. First, there was concern about the range of tax treatment applicable to income from entities operating in corporate form. Like others who worked on integration, there was concern about the double taxation of distributed

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<sup>34</sup> See OECD 2006 for a brief review of dual and "semi-dual" income tax systems in OECD countries and Barreix and Rocha (2007) on Latin America and Spain.

<sup>35</sup> For an examination of the U.S. tax system, see Zolt (1996). [Virginia Tax Review, Uneasy Case for Uniform Taxation].

<sup>36</sup> Sorenson (2007); Genser and Reurtter (2007).

<sup>37</sup> The Bush I Administration was concerned that the U.S. corporate income tax system hurt the international competitiveness of U.S. corporations.

<sup>38</sup> U.S. Treasury (1992). One of the co-authors, Eric Zolt, served as one of the co-directors of the study in his capacity as Deputy Tax Legislative Counsel, Office of Tax Policy, U.S. Department of the Treasury.

<sup>39</sup> Similarly, at the margin investment decisions with respect to industry, asset mix, location, risk-taking, and timing may be influenced by variations in effective tax rates. Inter-temporal decisions, like inter-sectoral decisions, are also affected by taxes on capital income, with the result that private savings are diminished. Moreover, the complexity of corporate taxes may impose significant costs and barriers to the expansion of new and small firms, while uncertainty as to the precise tax implications of various corporate decisions may act as a general deterrent to investment.

corporate income.<sup>40</sup> But there was also concern that income attributed to corporate entities was subject to zero tax (for example, interest income paid to tax-exempt entities or perhaps, portfolio interest paid to foreign holders) or three or more layers of tax (for example, for multiple levels of corporate holdings not subject to consolidation). The objective was to design a tax regime that subjected business income to a single layer of tax—not just a regime that eliminated the double taxation of distributed corporate income.

Second, in the U.S. as in other countries, there was a large proliferation of different types of legal entities that persons could choose to conduct business operations. While the Treasury group recognized the need for different types of legal entities for economic and legal purposes, the rationale for different tax treatment for the legal entities was much less compelling.<sup>41</sup> In particular, it was not clear why taxpayers should be able to elect the tax regime that applies their business activities. Here the objective was to design a tax regime that would be applicable to business income, without regard to the legal form that an individual or groups of individuals choose to conduct operations.<sup>42</sup>

Third, like other academics and policy makers who worked on integration, there was concern about the different tax treatment of debt and equity capital—not only at the corporate level (where interest paid on debt was deductible and dividends paid on common shares were not deductible), but also at the investor level. Here the insight was that holders of debt and equity had similar claims to the cash flow of the business activity, subject to different competing rights as to risk, return, duration and control.<sup>43</sup> Again, while strong reasons may exist for treating debt and equity capital differently for economic and legal purposes, the case for differential treatment for tax purposes is much less persuasive. Participants in economic activity should be subject to like taxation on their economic returns, without regard to the labels applied the form of their investment. Here, the objective was to eliminate the different tax treatment applicable to debt and equity.

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<sup>40</sup> Corporate income is taxed first when earned at the corporate level, and then again upon distribution to shareholders under the personal income tax. Corporate income may also be subject to double taxation when shareholders recognize capital gains attributable to previously taxed, but not distributed, corporate income.

<sup>41</sup> Klein and Zolt (1995). [Business Forms, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?, 66 U. Colo. L. Rev. 1001 (1995)].

<sup>42</sup> Possible exception for small businesses.

<sup>43</sup> Gulati, Klein and Zolt (2000). [Connected Contracts, 47 UCLA L. Rev. 887 (2000).]

The easiest way to eliminate the distinction between debt and equity in the corporate tax regime was either to provide for a deduction for dividends paid or to disallow the deduction for interest. The CBIT proposal provided for no deduction for interest payments as means of imposing tax liability on the share of business income attributable to debt capital.<sup>44</sup> This was the most controversial aspect of the CBIT proposal, one that resulted in clear winners and losers among corporate taxpayers and their investors.<sup>45</sup> Alternatively, the CBIT proposal could have included a deduction for interest at the corporate level and a tax on the investor level collected through final withholding (at the corporate tax rate).<sup>46</sup>

Simply put, CBIT was designed as a flat tax on business income, collected at the source (with no further taxation at the investor level).<sup>47</sup> For our purposes in this article, the key insight is that CBIT is a form of dual income tax as it imposes a flat tax on business income (regardless of form or label) while maintaining the progressive tax on labor income.

Other developed countries have considered similar issues and reached different conclusions. For example, in 2001, the Netherlands adopted a slightly different approach to schedular taxation than the Nordic model.<sup>48</sup> This approach, which the OECD (2006) characterized as "semi-dual," provides for three separate "boxes" of income: (i) taxable income from work and home ownership; (ii) taxable income from a substantial business interest; and (iii) taxable income from savings and investment. Each box is subject to its own tax rate and method of computing income. The law also provides for the quarantine of losses so that losses from each box may not offset income from any other box. The Netherlands tax law provides for progressive income tax rates for income in box 1 (primarily income from labor), a flat income tax rate for income from box 2 (primarily income from business activity), and a presumptive tax rate for income from

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<sup>44</sup> One way to characterize the denial of deductions is to treat as a form of substitute taxation on the recipient of the income. Substitute taxation achieves the same economic result as direct taxation if the corporate tax rate and the tax rate applicable to the investor is the same.

<sup>45</sup> The move to the CBIT regime would benefit those entities that rely relatively more on equity finance and penalize those firms rely relatively more on debt finance.

<sup>46</sup> This approach was problematic in the United States because of the current tax regime applicable to the large holdings of tax-exempt and non-resident investors in the U.S. corporate debt markets. This would likely be of less concern in developing countries. For a discussion of CBIT with final withholding on interest, see Cnossen (2000).

<sup>47</sup> As we discuss briefly later, it is difficult to determine how best to treat capital gains under any income tax regime (CBIT, DIT or flat tax) in the context of developing countries.

<sup>48</sup> Meussen (2000). [Gerard T.K. Meussen, *Income Tax Act of 2001*, 40 EUR. TAX'N 490 (2000)].

portfolio investments. Net assets in this last box are assumed to yield a return of 4%, and are subject to an income tax rate of 30%. This is the equivalent of a wealth tax of 1.2%.

There is something new and old about the Netherlands 2001 presumptive tax on portfolio assets. This is a new approach for the taxation of investment assets. If taxpayers in the Netherlands earn a 1% or 10% return on their portfolio assets, it does not matter as it is assumed the return is 4% for income tax purposes. It is an old approach in that it is similar to the presumptive tax approach of many 19th century tax systems that allowed taxing authorities to assess tax based on the estimated value of the asset without needing to trace and confirm the actual income generated by the asset.<sup>49</sup>

It is not clear whether this presumptive tax approach for portfolio assets would be desirable for developing countries. The Netherlands approach arose in the context of taxpayers structuring financial investments to generate return in the form of capital gains (which were exempt from tax) rather than as current income. In the Netherlands, the level of voluntary compliance is quite high and the ability of tax administration to monitor the investment assets of taxpayers is sufficiently robust to allow for this type of wealth tax. These conditions do not hold in most developing countries. If, however, the level of tax avoidance rises to the degree of sophistication seen in the Netherlands, developing countries are unlikely to tax effectively most income from portfolio investments. In such countries, a flat final withholding tax on portfolio income may be a more effective approach to taxing portfolio income.

### III. DUAL INCOME TAX IN DEVELOPING COUNTRIES

In this section we first examine the tax environment that exists in many developing countries and some of the differences between developed and developing countries that influence the adoption and design of a dual income tax regime. We then consider some of the design alternatives facing countries considering adopting a dual income tax regime. The last part examines the possible advantages and disadvantages of dual income tax regimes in developing countries.

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<sup>49</sup> Harris (2005). [See Peter A. Harris, *Origins of the Income Tax in the United Kingdom and Its Former Colonies to 1820* (2005) (unpublished manuscript, on file with author)].

### A. Tax Environment and Differences between Developed and Developing Countries that Might Influence the Adoption and Design of Dual Income Tax Regime

The tax environment in most developing countries differs substantially from the tax environment present in most developed countries. Taxing patterns differ. Developing countries rely relatively more on taxes on consumption, 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 as compared to developed countries. While the revenue from corporate income taxes from developing countries varies substantially by region, corporate income taxes provide a major source of revenue in many countries.

[add Table 2 here]

Spending patterns also differ. The size of the government sector is much smaller in developing countries (on average about half the level in developed countries), and spending on social programs are generally much smaller than in developed countries. Although there has been substantial progress in the last decade, governments in developing countries do much less either to alleviate poverty or to reduce inequality than governments in most developed countries.<sup>50</sup>

The composition of the sources of revenue under the personal income tax system varies substantially among countries. While it is difficult to get any cross-country information, we believe that generally substantially over 90% of personal income tax revenue in developing countries is from wage withholding in formal sector.

Many developing countries have a large traditional agricultural sector and a significant informal (shadow) economy, both operating largely outside the formal tax system. No country has managed to tax these sectors effectively (Alm, Martínez-Vazquez, and Wallace 2004). These hard-to-tax sectors constitute a much higher portion of total economic activity in developing countries than in developed countries.<sup>51</sup> As a result, the tax base that tax authorities can potentially reach is relatively small in many developing countries.

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<sup>50</sup> Chu, Davoodi and Gupta (2004).

<sup>51</sup> The size of the untaxed economy may itself be a function of the design and implementation of the tax system. For example, the high social insurance tax rates levied by some countries create an incentive for a large informal economy by discouraging employers from reporting the extent of

Tax systems in developing countries also raise relatively small amounts from “passive” income held by residents. To the extent residents have such passive income and the tax laws subject such income to tax, the tax administration is often unable to observe or tax such income. Indeed, with some exceptions, foreign source income in any form is largely beyond the grasp of tax administrations in most countries. Developing countries also receive little tax revenues from local passive investments held by non-residents. Even where the tax capacity exists, many developing countries have entered into tax treaties that trade away the right to collect income on passive investment held by foreign investors to attract more foreign direct investment. The extensive use of tax incentives to attract foreign investment countries may also substantially reduce the tax revenues from even the active income of foreign investors.

## B. Design Choices

Within the general dual income tax framework, several design options exist. Here is a menu of alternatives from which policy makers in developing countries may choose.

1. *Choice of tax rates.* The first set of design options involve choices as to the level of tax rates, the relationship of tax rates for income from capital and income from labor. Policy makers could consider different rates for different types of capital, such as choosing a lower rate on passive income from capital (portfolio income such as interest, dividends and certain types of rental income) as compared to income from active business activities. As policymakers are never writing on a clean slate, the best options for any particular country are inevitably strongly influenced by the tax rates of the existing tax regime, as well as the tax rates of other countries in the region.

2. *Level of taxes.* Marginal income tax rates under both personal income tax systems and corporate income tax systems have declined substantially over the last 40-plus years.<sup>52</sup> The dispersion of rates among countries has also narrowed considerably, particularly within regions. In Latin America, for example, the average tax rate on corporations fell from 41 percent in 1985 to 29 percent in 2003 and the top rate on personal income from 51 to 28 percent (Lora and

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employment and encouraging the under-reporting of wages (Rutkowski 2007). The resulting lower tax revenues often lead governments to raise tax rates still further, thus exacerbating incentives to evade taxes.

<sup>52</sup>Norregaard and Khan (2007).

Cardenas 2006). As markets for both labor and capital become more integrated, policy makers face greater constraints on their ability to set tax rates for labor and capital income. Such constraints are clearly much tighter for peripheral countries in the developing world than they are for larger more developed countries (like United States and Germany) that can to some extent tax agglomeration (location) rents without unduly discouraging investment.

For developing countries with relatively high top marginal rates under the personal income tax systems (35% or greater), the move to a dual income tax regime will likely mean substantial reductions in tax rates (which may allow policy makers the opportunity to expand the tax base).<sup>53</sup> However, how much room there is for tax reductions obviously depends on the distribution of taxable income.<sup>54</sup> But even countries with moderate or comparatively low marginal tax rates will likely face pressure to reduce tax rates as part of any major tax reform.

*3. Relationship of tax rates for capital and labor income.* The major policy decision in adopting a dual income tax regime is setting the relative tax rates for capital and labor income. While the Nordic countries set the rate for capital income at (or near) the lowest tax rate applicable to labor income, different considerations may apply in developing countries. In the pre-dual income tax regime of the Nordic countries, many types of capital income were subject to the high marginal tax rates applicable to income from labor. In contrast, the current personal income tax regimes in many developing countries, income from capital may escape taxation, or be subject to tax rates not tied to income from labor.<sup>55</sup>

It is interesting to consider the potential consequences from changing the relationship between tax rates for capital and labor. For example, setting the tax rate on capital at the highest rate applicable to labor income would reverse the tax incentives present in Nordic countries where taxpayers seek to characterize labor income as capital income. De Mooij and Nicodeme (2008) suggest that the income shifting resulting from lower corporate income tax rates in particular has,

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<sup>53</sup> Many of the flat tax reforms provided for an expansion of the tax base to help minimize revenue losses from rate reductions. See \_\_\_ (\_\_\_).

<sup>54</sup> In some developing countries, such as Papua New Guinea, almost all personal income tax revenues is actually collected from expatriates who are subject to the top rate of the personal income tax rate schedule. (Bird 1989).

<sup>55</sup> In some developing countries in Latin America, a variety of schedular taxes on some types of capital income already exist. However, these schedular capital taxes are generally applied at different rates to different types of capital income with many gaps: one argument for a DIT is precisely to restore symmetry in this area.

in the case of a number of European countries, shown up primarily in the form of lower personal income taxes as more and more small businesses have incorporated to take advantage of the tax differential.

Setting the tax rate on capital at the middle of the range would also create some interesting incentives. For taxpayers whose labor income would be taxed at the higher end of the progressive tax rate schedule, there would be incentives to characterize part of their income from labor as income from capital. But for taxpayers whose labor income would be taxed at the lower end of the progressive tax rate schedule, incentives would exist to characterize part of their income from capital as income from labor—but not so much as to move the labor income to a higher bracket.<sup>56</sup>

The trade-off is between achieving additional progressivity from taxing labor income and the potential distortions and arbitrage opportunities from the different tax rates applicable to income from labor and capital. While the spread in Nordic countries between the flat tax rate applicable to income from capital and the top rate under the progressive schedule for labor income, was (and continues to be) substantial, the difference between the tax rates for capital and labor income in many developing countries may be much smaller -- although again this depends whether there are substantial payroll finance Social Security systems (as in a number of Latin American, Eastern European and Central Asian countries) or not.

*4. Different tax rates for investment income vs. active business income.* An option that may be attractive to some developing countries maintains the progressive rate structure for labor income and provides for two different regimes for taxing income from capital: a relatively low flat tax rate on portfolio investment income and a higher flat tax rate on income related to active businesses. Uruguay adopted a version of this dual income tax system (or perhaps more accurately, a tripartite tax system) in July 2007.<sup>57</sup> Alberto Barreix and Jeronimo Roca provide a good description of the dual income tax regime that replaced the personal receipts tax system. Unlike the prior tax regime, the dual income tax regime imposed taxes on professional services, interest, rent and capital gains. Under the Uruguayan dual income tax, labor income tax is taxed at rates ranging from 10 to 25%. A substantial zero bracket excludes 60% of the population from the tax system. Portfolio income is taxed at a 12% rate through a

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<sup>56</sup> The existence, level and structure of payroll taxes for example to finance social security is also clearly relevant in this respect.

<sup>57</sup> Barreix and Rocha (2007).

final withholding regime. Self-employed persons can choose between being taxed under the business tax regime (at a 25% tax rate after deducting business expenses) or paying under the labor income tax regime at the 25% rate (with allowance for personal deductions and presumed expenses of 30% of receipts).<sup>58</sup>

5. *Scope of Dual Income Tax.* Essentially, a DIT is a schedular income tax that divides total income into capital and labor income and taxes each class of income differently. The capital income component can be defined more or less broadly. Some forms of capital income are simple to define in principle: interest income, dividends, royalties, and rents. Even in developing countries, it should be relatively easy to tax the first three of these items at a flat (final) rate. Indeed, if it can be done, applying the same rate to all such payments from firms to domestic residents and also to similar payments to foreigners would constitute both an improvement in efficiency owing to the increased symmetry of treatment of capital income and a considerable administrative simplification. Moreover, although some treaty adjustments may be required, it would also in some countries both expand the tax base and improve the overall progressivity of the tax system by incorporating in the tax base income that is now treated as being paid to foreigners when in fact it is flowing to domestic residents who are not known to the tax authorities to be domestic residents. If desired, it would presumably be equally simple to apply this tax to returns from pensions and other tax favored savings although doing so would of course raise certain additional policy considerations.

Taxing rents, let alone the rental value of owner-occupied real estate, would be much more difficult outside the purely commercial sector given the limited administrative capability in most developing countries. Much the same can be said with respect to capital gains. However, other approaches could be taken to deal to some extent at least with both of these problems through other tax instruments, if desired. For example, both owner-occupied properties and capital gains on real property would of course be taxed to some extent through any properly functioning property tax capital, although such taxes are few and far between in developing countries (Bird and Slack 2004). In addition, gains on real property might perhaps be taxed through the value added tax using the "margin" method, as suggested by to Cnossen (2008). This approach is particularly attractive in both allocative and equity terms for countries in which the income tax and value added tax rates are fairly close. It would also be easier to

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<sup>58</sup> Id.

administer in countries that already have real property transfer taxes (which tax the entire value of the transaction rather than simply the gain).

6. *Integration of personal and corporate tax systems.* With the reduction of personal and corporate tax rates, the need to provide specific provisions to reduce the double taxation of distributed corporate income (and the double taxation associated with capital gains attributable to previously taxed corporate income) may be much reduced in developing countries. With respect to capital gains on corporate shares, if the corporate tax rate is set equal to the capital income tax rate under the dual income tax, then not only can dividends be exempt from withholding taxes but in effect the proportion of share capital gains attributable to increased corporate earnings is also taxed at the same rate.<sup>59</sup> Although it is difficult to think of an administratively feasible way to tax the component of real capital gains on shares attributable to goodwill, even this limited leveling out of the tax arbitrage playing field would be a substantial improvement in most developing countries.

7. *Treatment of Self-Employment Income and Taxation of Closely-Held Businesses.* As the discussion in section 2 of the Nordic experience indicated, one of the most difficult problems in designing a DIT is the treatment of personal business income since such income is a mixture of labor and capital income. In the Nordic systems, in general the tax rate on capital income is equal to the lowest rate applied labor income to reduce arbitrage. In contrast, in the Uruguayan system the rate on business income is set at the highest rate on labor income while the rate on capital income is set equal to the lowest rate on labor income. The appropriate solution for a particular country depends both on the likely magnitude of the erosion in tax base likely to be stimulated by the spread in tax rates and arbitrage opportunities as well as on the capacity of the tax administration to catch those who push too strongly on this weak point in the system. An additional important factor is the extent of the change in the incentives facing taxpayers to alter the form of their operations and the nature of their reported income compared to the incentives offered by the pre-existing tax regimes for capital and labor. In countries in which the formal sector is taxed at very high rates but the existing effective rates of tax on most forms of capital income are probably very

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<sup>59</sup> Dividend exemption is not an essential element of the DIT: if full (dividend) integration is not desired, dividends can be subject to tax (the "classic" system) or partial imputation can be provided by crediting DIT withholding to the desired extent.

low in practice, introducing a dual income tax may actually reduce the incentive to lie to the taxman.

8. *Coordination with payroll or social security taxes.* Developing countries differ substantially with respect to their use of payroll and social security taxes. In some regions, such as Africa and some Latin American countries, these taxes play a relatively small role. In other regions, most notably the transition countries and a few Latin American countries (such as Argentina, Colombia and Uruguay), payroll and social security taxes play a major role. As discussed in Section \_\_, in those countries the tax burden on labor income may be substantially higher and the relationship between payroll or social security tax liability and benefits received under the expenditure side of such systems may be quite weak.

Where payroll and social security taxes are substantial, it makes sense to coordinate the dual income tax reforms with social security tax reforms. In particular, it might make sense in such cases to rethink whether it is appropriate for labor income in the formal sector to bear the principal costs of social programs or whether it may be better to shift a substantial proportion of the cost either to the value-added tax (as Avi-Yonah (2008) suggests) or to a new much broader base, much less distortionary dual income tax. If the latter path is chosen, it would seem to make good sense to think of combining the existing payroll taxes to a considerable extent with the labor component of the new DIT, for example, with respect to the rate structure in the zero bracket amount as well as administrative devices such as quarantining that are intended to prevent shifting of labor income to capital income -- or vice versa.

9. *Zero-bracket amounts.* Under the existing flat tax regimes, discussed in the next section, countries have taken different approaches to the size of the "tax free minimum" -- the zero bracket amounts or basic allowance. While in most countries this decision seems to have been driven largely by revenue concerns, there are also a number of other important design elements that should be taken into account. One particularly important selling point might be that raising the zero bracket amounts would free a substantial number of existing taxpayers from the obligation to file income tax declarations.<sup>60</sup> Particularly important in developing countries is the relationship between the DIT and the presumptive regimes that most such countries apply to many taxpayers who are either

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<sup>60</sup> This factor was important in Uruguay (Barreix and Roca 2007).

operating in the informal sector or are considered too small to be worth including in the regular tax system. We discuss this further below.

Another issue that might be considered is whether there should perhaps be a zero bracket amount for capital income. This may be especially relevant for business income in order to encourage small enterprises to save and invest and ideally grow themselves into the formal tax system at some point. Such an approach seems unlikely to be sensible in most developing countries, however, since they are unlikely to have a sufficiently good reporting system to provide for refunds for small savers.

*10. Use of information reporting and provisional or final withholding.* In effect, the capital income tax component of the DIT is a final withholding system. As noted earlier, the use of this withholding regime may also facilitate cooperation with tax authorities in other countries. It is difficult to monitor the foreign source income of residents without some type of international exchange of information. At least for most countries, the mutual exchange of information (and revenue allocation) likely results in revenue gains to both countries.<sup>61</sup>

### C. Advantages and Disadvantages of Dual Income Tax Regimes in Developing Countries

The move to a dual income tax regime offers several advantages and disadvantages as compared to the current tax regimes in developing countries. As circumstances differ greatly among countries, so do the relative advantages and disadvantages, as well as the relative costs and benefits from undertaking major tax reforms. In some instances, of course, these advantages could be achieved by reforms other than moving to a dual income tax regime.

First, the move to a dual income tax regime could help rationalize the taxation of portfolio capital income. Throughout the developing world (as in the developed countries), different regimes for taxing interest and dividend income for domestic and foreign investments exist, as do different approaches to capital gain taxations. While it would obviously be most advantageous if the same regime could be applied to such payments whether made to residents or foreigners, a DIT regime would still be a significant improvement even if it applied only to domestic payments.

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<sup>61</sup> Keen and Ligthart (2006).

Second, adopting a dual income tax regime may provide the opportunity to coordinate with existing presumptive tax regimes to facilitate move into a “regular” tax system. The design of tax systems for micro and small enterprises (MSE) has recently been placed high on the agenda of international tax agencies concerned with improving tax systems in developing countries (IMF and IDB papers at Buenos Aires conference; World Bank paper). However, little attention has so far been paid to the critical issue of how to relate any special systems developed for MSE -- let alone the countless crude presumptive systems already in place around the world -- either to the corporate income tax and the value-added tax, basic pillars of the tax system in most developing countries, or to the dual income tax, which we suggest may often prove a promising way to turn the personal income tax into a third basic tax pillar.

Third, a dual income tax regime may perhaps allow for reduced use of corporate tax incentives. A lower rate on business income, and a lower corporate tax rate could allow for eliminating or reducing special tax incentives regimes designed to attract foreign investment. Of course, we are not so optimistic as to think that countries will stop creating redundant and ineffective incentives, but at least the incentive for them to do so would be reduced.

Fourth, tax reform could provide for simplification of regimes for both individual and corporate taxes, thus reducing both administrative and compliance costs. The latter point is particularly important given the extent to which such costs appear to create a substantial fiscal barrier to the formalization of many economic enterprises in developing countries.

Fifth, the move to a dual income tax regime could result in significant administrative gains from increased use of information reporting as well as increased use of provisional and especially final withholding. Compliance costs should also be reduced although of course, as with flat taxes, the precise extent of such cost reductions depends to a considerable extent on the extent to which the base of the taxes is broadened.

Sixth, the move to a dual income tax regime may result in possible revenue gains. These gains would be greater the less effective the prior tax treatment of income from capital and the more the change to the DIT tended over time to reduce the size of the informal economy.

Seventh, recognizing the reality of the ineffectiveness of the taxation of capital income most countries, there may even be possible progressivity gains,

particularly if the final result is to reduce tax on low income wages and increase tax on higher income wages and capital income.

While the weight to be attached to either the revenue or the progressivity points is certainly debatable in general and requires careful specific examination of particular suggested reforms in specific countries, any move to a dual income tax regime of course also involves some costs. For example, as in the Nordic dual income tax systems, arbitrage opportunities exist to convert labor into capital income. On the whole, however, this arbitrage problem is likely to be of less concern in developing countries, especially since there is almost certain to be a smaller difference in rates for capital and labor income than in developed countries. Alternatively, some variant of the Uruguayan model might perhaps be adopted.

An additional important question to be considered is of course the basic normative rationale for taxing different types of income at different rates. When thinking about this point it is important to think not to compare the DIT to some ideal tax regime with high levels of tax compliance, but rather to the highly imperfect and low compliance regimes actually prevailing in most developing countries. When the major challenges facing tax administrators in those countries are also taken into account, the classic comprehensive personal income tax model is clearly out of reach in the non-distributional grounds and a dual income tax approach may be viewed more favorably.

#### IV. DUAL INCOME TAX VERSUS FLAT TAX REGIMES

If policymakers seek to retain an income tax, they face several competing tax reform options. Choices include trying to improve the comprehensive income tax model, adopting a dual income tax, or adopting a flat rate tax. This section first provides a brief overview of the relatively recent flat tax reforms and then examines several factors that may influence the choice between a flat tax and dual income tax regime.

At one level, the choice between a dual income tax regime and a flat tax regime is quite stark: the dual income tax regime provides for a single tax rate on capital income while, at least in the early versions, the flat tax regime provides for a single tax rate on labor income. But, in many instances the differences between the two types of regimes may be less than might appear. This would be true where the range of tax rates under a progressive income tax on labor was relatively

narrow (or where a “basic” tax rate applied to a high percentage of the population) and was closely aligned with the rate applicable to capital income,<sup>62</sup> or, as discussed below, where the flat tax regime also covers different types of income from capital.

#### A. Recent Flat Tax Reforms

Several recent tax reforms, particularly in Central and Eastern Europe and the countries of the former Soviet Union, have followed a “flat tax” approach. These flat tax reforms are income tax systems that apply a single tax rate above an exempt amount.<sup>63</sup> As discussed below, though clumped together under the flat tax rubric, these reforms vary substantially across countries and over time.<sup>64</sup> They differ in choice of the tax rate as compared to the range of tax rates before the reform, the types of income subject to the single tax rate, the size of the zero bracket amount (the basic allowance), the treatment of interest, dividends, and capital gains, and the relationship of the personal income tax rate and corporate tax rates before and after the reform. They also differ with respect to interaction with other aspects of their tax system such as other taxes on labor (social security or payroll taxes), changes in the scope and level of VAT and excise taxes, and trade taxes.<sup>65</sup>

These flat tax reforms are not the consumption-style “flat taxes” of the type that have dominated recent tax discussion in the United States.<sup>66</sup> These reforms retain income as the tax base, but eliminate multiple positive marginal tax rates with respect to certain types of income.<sup>67</sup> The first wave of flat tax reforms (Estonia 1994; Lithuania 1994; and Latvia 1995) generally provided a moderately high single tax rate as compared to the previously existing tax rates in those countries and as compared to international tax rates. The reforms applied only to the personal income tax systems and left the separate corporate tax regime (with often higher corporate tax rates) unchanged.

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<sup>62</sup> When the Swedish dual income tax regime was first adopted, the basic tax rate on labor income applied to 90% of the taxpayers, and the basic tax rate was set at the tax rate applicable to income from capital. Larson, TNI. Earlier examples of flat income tax systems include Hong Kong and Jamaica.

<sup>63</sup> Jenn (2007); World Bank 2007.

<sup>64</sup> Keen and Ligthart (2006); Jenn (2007).

<sup>65</sup> Keen and Ligthart (2006); Jenn (2007).

<sup>66</sup> Cite Hall Rabushka and Bradford X taxes.

The second wave of flat tax reforms (Russia 2001; Ukraine 2004; Slovak Republic 2004; Georgia 2005; and Romania 2005) provided for a flat rate substantially below previous personal income tax rates and low rates relative to international tax rates. The flat rate in Georgia is 12%, and in Russia and the Ukraine, 13%. Of the countries in the second wave, only the Slovak Republic and Romania adopted the same tax rate for corporate taxes as the rate applicable under the personal income tax system.

[add Table 3 here]

Based on the current flat tax reform efforts, it is difficult to identify a single flat tax model. For discussion purposes, we offer three stylized flat tax models:

*Type A* model applies a flat tax to labor income, including income from sole proprietorships and partnerships. Separate tax rates (and regimes) continue to apply to corporate income. This model does not subject income from dividends, interest, and capital gains to the flat tax rate (this income could either be tax-exempt or taxed at a different rate);

*Type B* model applies a flat tax to all personal income, including income from sole proprietorships and partnerships, and income from interest, dividend, and capital gains but not income earned by corporations;<sup>68</sup>

*Type C* model applies a flat tax to all personal and business income, such that a single tax rate would apply to income of individuals and corporations and provide from tax relief for distributed corporate income.

#### B. Considerations for Developing Countries in Choosing Between a Dual Income Tax and Flat Tax System

While it is difficult to make comparisons between the dual income tax model and the flat tax model without having specific details of the proposals, we offer the following observations.

Depending on where policymakers set the single marginal tax rate on capital income, the tax rate on labor income could be either the same or higher (if the capital income tax rate is set at the lowest possible rate on labor income), or the tax rate on labor income could be either lower, the same, or higher, depending on

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<sup>67</sup> With the exception of Georgia, these reforms retain a zero-bracket amount, so provide for some progressivity in the tax system.

the rate of progressivity under the labor income tax and the rate chosen for capital income.

So, phrased differently, the difference between the two approaches is essentially what is gained or lost by having a progressive rate schedule for labor income combined with a flat tax rate on capital income. In general, the dual income tax looks better than a flat income tax for several reasons.

First, we think it likely that a sustainable fiscal system in most countries in which policy in the long run must satisfy social norms will require at least a modest degree of explicit tax progressivity. The personal income tax is the only fiscal instrument available for this purpose in most countries.

Second, market-driven developing countries generate both growth and inequality. Their dilemma in capsule form is how to maintain high growth rates without being derailed by political and social tensions created by growing inequality. If one believes that an essential element in sustaining growth (and political stability) is to provide at least some check on the ability of those with great private incomes and wealth to influence political outcomes, a sustainable democratic tax system must have some explicit way of taxing the rich more than the poor. Since personal wealth taxes are likely to become any more popular anywhere than they now are, the combination of a more effective flat rate taxation of capital income, a high proportion of which accrues to the rich, and a moderately progressive tax on wage income, which has in recent years become increasingly unequal in many countries, is probably essential. This is exactly the combination provided by the DIT.

Third, in addition sustainable growth also requires in most developing countries an expanded state in order to replace the "insurance" formerly provided for much of the population by extended rural families. It also requires an increasingly educated population and expanded infrastructure. All this requires growing state revenues, and hence an overall marginal rate of taxation exceeding the average rate. In short, at least modest progressivity in the taxation of labor income is likely to be an essential component of the growth and economic and political sustainability of most countries.

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<sup>68</sup> In practice, Type A and Type B flat tax models are probably quite similar in the context of most developing countries in which most personal income tax revenue generally comes from taxes on labor income in the formal sector of the economy.

The dual income tax looks better than the flat tax precisely because it includes a more explicit progressive element in the form of a progressive rate structure rather than simply a zero bracket. It is not enough to tax the not so poor at a higher rate than the poor; as a rule, one must also tax the rich more than the merely well-off and more than the average worker as well.

The dual income tax is similarly better in the context of most developing countries than the usual hybrid comprehensive tax model for several reasons.

First, it provides more symmetric and less distorting treatment of capital income.

Second, it provides a simpler and more effective way to tax capital income, thus in all likelihood both expanding revenues and making the tax system more progressive.

Third, it achieves both these objectives with less administrative strain and effort than it would take to do the same using a comprehensive income tax approach. This is not a minor consideration in countries in which administrative capacity is a severe constraint on tax policy.

Fourth, the introduction of explicit dual income tax approach strengthens rather than weakens the role of the personal income tax and the overall tax system, thus better achieving social and political objectives of the income tax mentioned earlier.<sup>69</sup>

Fifth, by decoupling the taxation of wage and capital income tax policy makers have an additional degree of freedom which may, for example, make it easier for them to avoid complicating either component of the income tax system by various "incentive" provisions.

Sixth, a dual-income tax properly designed for the circumstances of a particular country may lay the foundation for a broader modular approach to overall tax reform. As we have discussed, a DIT opens the door to a coherent set of reforms that are needed in many developing countries with respect to such related issues as the taxation of international income flows, the integration of corporation and personal income tax, the reform of corporate taxation, the integration of presumptive (small business) and normal tax regimes, and the integration of payroll and income taxes.

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<sup>69</sup> Adopting a DIT would make it simpler for sub-national governments to piggyback on the labor portion of the tax. Boadway (2005).

## V. CONCLUSION

We seek not to replace the income tax in developing countries but to improve it. The dual income tax regime combines a progressive tax on labor income with a flat tax rate on capital income. A flat tax rate on capital may provide an opportunity both to rationalize the taxation of different types of “passive” income from capital and to eliminate many of the tax preferences contained in the personal and corporate tax systems. In particular, the move to a dual income tax system provides a uniform lower capital tax rate which if set at the same level as the corporate income tax should reduce the apparently fatal attraction for many developing countries of tax incentives that often erode the tax base, provide incentives for rent-seeking and corruption, and serve to provide greater benefits to foreign, rather than, domestic investors. At the same time, retaining a progressive tax on labor income will provide some progressivity in countries where economic changes result in greater inequality. The combination of the two features provides an opportunity to substantially improve tax policy and tax administration in many developing countries.

Dual income tax systems have worked relatively well in the Nordic countries. If developing countries seek to follow this approach, they have plenty of options with respect to the details of a proposed dual income tax regime. For example, the flat personal tax rate on income from capital could follow either the Nordic model and be set at or near the lowest positive tax rate for labor income, or be set at the middle or top of the progressive rate schedule for labor income. To improve compliance, countries could provide for final withholding for dividends and interest payments from corporations (or expanded to cover other payors).

Developing countries could also choose to follow the Uruguayan model, and provide for a flat tax rate on passive income from capital at the lowest positive tax rate on labor income and provide for a flat tax rate from capital from sole proprietorships and closely held corporations at the middle or highest rates.

In all cases, it likely makes sense to set the corporate income tax rate at the same tax rate as income from active business income under the personal income tax system. Consideration could also be given to coordinating this tax rate with the tax rates under the different presumptive tax regimes that many developing countries apply to tax small businesses. Depending on complexity, revenue and other factors, consideration could be given to providing some degree of relief from double taxation under the personal and corporate income tax systems.

While the dual income tax provides for a single rate on income from capital, at least initially, the flat taxes adopted in Eastern European countries and the countries of the Former Soviet Union provide for a single tax rate on income from labor. To the extent that the scope of these flat tax regimes increase to cover income from capital under the personal income tax regimes and income under the corporate tax regimes, these tax regimes also may achieve the goals of symmetry and comprehensiveness, and depending on the rate adopted, competitiveness. Although it is empirical question, it is likely that even expanded flat tax regimes sacrifice progressivity as compared to the dual income tax. Of course, it would be simple to alter such a flat tax system into a dual income tax system if desired.

Obviously, different developing countries face different challenges in reforming their tax system; different environments, different objectives, capacities and policy trade-offs all come into play. There is and can be no one solution to all tax problems in any country. For the reasons set forth above however we suggest that the dual income tax approach provides an exceptionally promising basis on which to construct more rational and sustainable and productive -- and perhaps even more progressive -- tax systems in many developing countries.

Table 1. The Nordic Dual Income Tax (2006 tax rates in %)

	Norway	Finland	Sweden	Denmark
Implementation of DIT	1992	1993	1991	1987
Personal income tax rates				
-capital income	28	28	30	28/43 <sup>a</sup>
-earned income	28-40	26.5-50 <sup>d</sup>	31.6 <sup>d</sup> -56,6	38.8-47.9 <sup>f</sup>
Basic allowance for capital income	Yes	No	No	Yes
Offset of negative capital income	First bracket	Tax credit	Tax credit	Tax credit <sup>g</sup>
Integration of corporate and personal income tax	RRA (rate-of-return allowance)	Listed companies: Reduced PIT rate Unlisted companies: RRA	Listed companies: Reduced PIT rate Unlisted companies: RRA	Reduced PIT rate
Corporate income tax rate	28	26	28	28
Withholding tax for residents (nonresidents)	No (No)	19.6 <sup>c</sup> (28)	30 (30)	28 (28)
-dividends	28 (28)	28 (28)	30 (No)	No (No)
-interest				
PIT on capital gains	28 <sup>c</sup>	28	30	28
Net Wealth tax	0.9-1.1	No	1.5	No
PIT unit	Household Option for individual taxation	Individual	Individual	Individual
Income of children	Included	Taxes separately	Taxed separately	Taxes separately

Notes: <sup>a</sup>28% for income from shares (dividends and capital gains on shares) below threshold, 43% else; other capital income is taxes as earned income.

<sup>b</sup>local income tax only; additional federal income tax is due for income levels exceeding a threshold of 306000 SEK

<sup>c</sup>net of retained earnings

<sup>d</sup>for the municipality of Helsinki

<sup>e</sup>28% on 70% of the dividend income

<sup>f</sup>national income tax (5.48%-15%) plus local income tax (32.9% for the municipality of Copenhagen)

<sup>g</sup>for local tax only

Table 2. Tax Structure by Region, Percentage of Total Tax Revenue, 1975-2002

	Income Tax			Domestic Goods and Services			International Trade
	Total	Individual	Corporate	Total	General Consumption	Excises	
<b>North America</b>							
1975-1980	78.4%	56.9%	20.5%	15.0%	7.7%	6.5%	6.6%
1986-1992	78.8%	63.5%	14.4%	17.0%	9.8%	6.3%	4.3%
1996-2002	83.3%	66.3%	15.8%	14.8%	8.8%	5.1%	1.8%
<b>Latin America</b>							
1975-1980	32.7%	11.1%	17.6%	40.4%	17.1%	19.3%	26.8%
1986-1992	31.1%	8.5%	17.6%	47.3%	20.9%	21.0%	21.5%
1996-2002	30.4%	6.2%	18.5%	56.3%	34.0%	16.1%	13.3%
<b>Western Europe</b>							
1975-1980	42.7%	33.3%	8.5%	50.6%	28.6%	16.5%	6.7%
1986-1992	43.4%	32.9%	9.3%	53.4%	33.4%	14.9%	3.2%
1996-2002	47.2%	32.8%	13.0%	52.4%	31.8%	15.0%	0.3%
<b>Asia</b>							
1975-1980	38.8%	22.9%	20.5%	37.2%	14.3%	18.3%	24.1%
1986-1992	39.3%	20.8%	19.2%	39.5%	17.4%	16.7%	21.2%
1996-2002	46.9%	24.2%	21.4%	40.2%	19.6%	15.3%	12.9%
<b>Africa</b>							
1975-1980	32.1%	14.6%	16.1%	29.7%	18.4%	13.5%	38.2%
1986-1992	27.4%	14.6%	11.4%	31.9%	18.3%	11.9%	40.7%
1996-2002	30.7%	17.7%	11.6%	36.2%	21.8%	11.3%	33.2%

*Sources:* IMF Government Finance Statistics (July 2004); Shome, Parthasarathi, ed., Tax Policy Handbook (IMF 1995), tpls. 1-30; Japan Ministry of Finance; Mexico Ministry of Finance and Public Credit.

*Notes:* To maintain consistency of measurement and to allow cross-country comparisons between tax structures, the table reflects consolidated central government revenue for most countries. However, if these data were unavailable, national budget data, or some combination of national, state, and local revenues were used. To even out annual fluctuations, the figures are averaged over 1975-1980, 1986-1992, and 1996-2002.

Table 3. Current Flat Taxes

	Year	PIT Rate 1/	PIT Rates Before Reform	CIT Rate 1/	Cit Rates Before Reform	PIT 2007	CIT 2007
Estonia	1994	26 2/	16, 24, 33	26 3/	35	22	22
Lithuania	1994	33	Rates 18-33	29	29	27 4/	15
Latvia	1997	25	10 and 25 5/	25	25	25	15
Russia	2001	13	12, 20, 30	37 6/	30	13	24
Slovakia	2004	19	Five rates, 10-37 7/	19	25	19	19
Ukraine	2004	13	Six rates, 10-40	25	30	15	25
Georgia	2005	12	12, 15, 17 and 20	20	20	12	20 8/
Romania	2005	16	Rates 18-40	16	25	16	16
Kyrgyzstan	2006	10	Rates 10-20	10	20	10	10
Macedonia	2007	12	Rates 15-24	12 9/	15	12	12 9/
Iceland 10/	2007	35.7		18	18	35.6	18
Mongolia	2007	10	10, 20 and 40	25	15 and 30	10	10/25
Montenegro	2007	15	15, 19, 23	9	9 11/	15 12/	9
Kazakhstan	2007	10	5-20	30	30	10	30
Albania	2007	10 13/	1-20	20	20	10 13/	20 13/
Czech Republic	2008/14	15 15/	12-32	22 16/	24	12-32	24
Bulgaria	2008/17	10	20-24	10	10	20-24	10

Source: Keen, Kim and Varsano (2007).

Notes:

- 1 Rates (in percent) as of time of introduction of flat tax.
- 2 Further rate reductions are planned: to 20 percent in 2009, 19 percent in 2010 and 18 percent in 2011.
- 3 Estonia subsequently reduced the CIT on retained profits to zero, with dividends taxed at the PIT rate. Rate planned to be reduced in step with the PIT rate.
- 4 Rate planned to be 24 percent from 2008.
- 5 Latvia, before introduction of the flat tax, reduced the number of rates to two in 1994 (35 and 25 percent) and cut the rates to 25 and 10 percent in 1996.
- 6 Maximum rate, including possible (capped) regional and municipal components.
- 7 On average production earnings, the average PIT rate was about 20 percent.
- 8 Georgia is considering reducing the CIT to 15 percent from 2008 onwards.
- 9 Rates will be 10 percent from 2008 onwards.
- 10 In 2006 the PIT rate comprised of a central government tax of 23.75 percent, a municipal tax of 12.97 percent and a central government surcharge of 2 percent. In 2007, the central government rate was reduced to 22.75 percent and the surcharge was removed, thereby turning the PIT into a flat tax. The corporate tax rate was reduced from 30 percent to 18 percent in 2002.
- 11 Until 2005 two tax rates of 15 percent and 20 percent were applied.
- 12 It is planned to reduce the PIT rate to 9 percent by 2010.
- 13 PIT rate reduced to 10 percent July 1, 2007 and to be reduced to 10 percent for CIT from January 2008.
- 14 On June 7, 2007, the proposed reform was approved in its first reading by the lower house of parliament. The proposed reform envisages a further reduction to 12.5 percent in 2009.
- 15 This rate would apply to income inclusive of the 35 percent employers' social contributions, so that the implied rate on income exclusive of these contributions—comparable with other rate figures in the table—would be 23.1 percent. Mandatory contributions of self-employed individuals (21.55 percent of net income) would be treated as nondeductible, while the 12.5 percent employers' contributions are and would continue to be deductible.
- 16 Rate reductions planned, to 21 percent in 2008, 20 percent in 2009, and 19 percent in 2010.
- 17 Bulgaria reduced its CIT rate from 15 percent to 10 percent in 2007.

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