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Fundamentals of Personal Income Taxation

FUNDAMENTALS OF TAXATION SERIES

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Fundamentals of Personal Income Taxation

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This comprehensive primer delves into the legal intricacies of personal income taxation, offering a globally relevant perspective on a subject central to modern tax law and policy. With the same rigorous methodology as its predecessor, *Fundamentals of Taxation: An Introduction to Tax Policy, Tax Law and Tax Administration*, this book unpacks the complexities of personal income tax without anchoring itself to the specifics of any single tax system.

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Production of This Work

This is a multi-authored book. While each author was tasked with the initial drafting of aspects of the book, the book is and remains a collaborative single manuscript. The different chapters reflect the joint views of the authors as a whole but not necessarily those of each author. The initial division of work is recorded as Pasquale Pistone (preface and chapter 7); Jennifer Roeleveld (chapter 5); Johann Hattingh (chapter 8); João Félix Pinto Nogueira (chapters 2 and 3); Joanna Wheeler (chapter 4); Craig West (chapter 1); Alessandro Turina (chapters 6 and 7, and sections 10.1.-10.3.); Ivan Lazarov (chapter 11); and Sergio Messina (section 10.4. and chapter 12).

This book will be followed by a volume on the Fundamentals of Corporate Income Taxation. Certain sections of the texts may partially overlap on issues similar in substance for both personal and corporate income tax regimes.

Peer Review Process and Statement

This statement serves to confirm that the full manuscript of this book was subjected to external peer review. For this external peer review, three independent international academic experts in the field were tasked with reviewing the manuscript. In particular, the reviewers were asked to comment on whether the manuscript provides an original analysis based on thorough knowledge of the existing literature on the subject. Upon receipt of the positive reviews, the manuscript was accepted for publication.

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Preface

This book aims at promoting technical legal education on personal income taxation with the same methodology used in the earlier book *Fundamentals of Taxation: An Introduction to Tax Policy, Tax Law and Tax Administration*. This methodology disentangles the analysis of personal income taxes from the positive dimension they might have in different countries. In this sense, this book should not be seen as a comparative tax law primer since it only includes reference to some countries as concrete examples of the measures it studies. This means it is a book that promotes a common understanding of the relevant issues. It aims to facilitate a transparent worldwide dialogue, prompting greater awareness of the policy implications that global tax governance might produce. This also allows this primer to interact with other research products of IBFD, which pursue a comprehensive assessment of personal income taxation.

The global dimension of personal income taxation has steadily grown over the years, more recently also in connection with increased international mobility and the remote exercise of activities. Moreover, countries nowadays watch each other's tax systems, intending to offer attractive tax measures that prompt individuals to relocate and preserve their own sovereignty from beggar-thy-neighbour tax policies enacted by other countries. Such considerations should not lead the readers to regard this as a book on the international legal aspects of personal income tax (even though such aspects are thoroughly addressed in chapters 3 and 8) but rather as a global instrument that educates them on the underlying reasons for the legal features of personal income taxation. This is how this global personal income tax law primer intends to fulfil its objective and purpose.

While this book follows the earlier *Fundamentals of Taxation: An Introduction to Tax Policy, Tax Law and Tax Administration*, this primer can be combined with it or be used on a stand-alone basis by the wide range of readers at which it is targeted. The most obvious category of readers is university students of a (module of a) tax law course. As the book is not grounded in any particular personal income tax system, for such students, it should make no difference if they use it in their studies at a university in a developing or developed country. However, the universal nature of the book makes it accessible to all other interested readers. Such readers might even include those who come across taxation during their studies or are just curious to understand better what personal income taxation is about, what legal issues it raises and how they might be approached and addressed. Moreover, the simple way in which it explains its object can also make it suitable for

legal experts who lack technical foundations in personal income taxation and for non-legal experts of taxation who believe that law is nothing but a mere instrument with which to implement tax policy options.

The 12 chapters of this book provide a comprehensive analysis of the legal issues raised by personal income taxes, guiding readers with a step-by-step approach to the issues. The chapters follow a logical order that starts with the object and scope and continues with the other essential elements of personal income tax, its procedural issues, and relationships with other selected taxes and levies until reaching more specific topics, such as tax planning and tax avoidance and the special regimes.

Since this preface is meant to introduce the core content of this primer, it might be useful to provide a brief comment on the content of each of the chapters.

The book's first eight chapters present the core aspects of personal income taxation. After putting the topic in context (chapter 1), these chapters address the critical questions of personal income tax: who to tax? (chapter 2), where to tax? (chapters 3 and 8), when to tax? (chapter 4), on what should tax be levied? (chapter 5), how much tax to levy? (chapter 6) and how should the tax be levied? (chapter 7).

Chapter 1 begins by putting personal income tax into context, and consists of four main topical blocks, which outline the contours of personal income taxation and review its function within the tax system in light of a historical overview that addresses its fundamental principles and relationships with other taxes.

Chapter 2 focuses on the personal scope and elaborates on the concept of taxable persons, also covering non-individual entities liable to this tax and the relationships with corporate income taxation. In short, it looks at who is liable for personal income tax. Also, it includes a dedicated analysis of the issues raised by groups of closely related individuals, including the family, which it addresses regarding its implications for the attribution rules.

Chapter 3 enriches the scope of the analysis with an emphasis on the nexus to tax jurisdiction, addressing the territorial implications of personal and objective nexus, which are presupposed by residence and source-based taxation.

Chapter 4 is dedicated to timing issues, examining a broad range of issues, from the methods for recording income across different categories and the related administrative issues to retroactive and retrospective taxation.

Chapter 5 examines the objective scope and elaborates on determining the taxable base, grouping them by different categories of income that private individuals may derive.

Chapter 6 analyses tax rates, explaining the rationale for most personal income systems to include progressive taxation, the implications of regressive taxation and the possibility of applying different tax rates to different income categories.

Chapter 7 contains a comprehensive review of procedural aspects, starting with advance rulings and self-assessment and continuing to non-coercive and coercive collection, including administrative reviews and judicial appeals.

Chapter 8 brings together the cross-border dimension of personal income taxation. Based on the nexus elaborated on in chapter 3, this chapter looks at how residence-based taxation and taxation of non-residence operate, including the related obligations that arise for private parties and states concerning the levying of taxes.

The remaining chapters supplement the analysis of the basic issues of personal income taxation, addressing key issues related to other taxes and levies.

Chapter 9 supplements the analysis of personal income taxes with analysis of those levied on capital. Despite being a separate set of taxes, their analysis allows this primer to address how they supplement personal income tax, both when applied in the form of net wealth tax and *inter vivos* (i.e. gift taxes), and *mortis causa* (i.e. inheritance and estate taxes) transfers of wealth. The structure of this chapter resembles that of chapters 2-7 regarding personal income tax.

Chapter 10 singles out social security contributions from personal income taxes in a way that shows their fundamentally different goals, and also some commonalities.

Chapter 11 presents the issues connected with failing to comply with the obligations connected with personal income taxation. In line with the legal

methodology, this chapter differentiates between tax planning, tax avoidance and tax evasion, which are also reviewed in light of the powers of tax authorities and the reporting obligations of private intermediaries.

Finally, chapter 12 completes the analysis with an overview of special regimes for relocation of individuals, shedding some light on their justification and background, and also providing some rather detailed information as to the types of measures that special tax treatments can concretely present.

Chapter 1

Introduction: Purpose of Personal Income Taxes and Evolution of the Tax Systems

1.1. Introduction to personal income tax

1.1.1. What do we mean by a “personal income tax system”?

Personal income generally refers to the realized and unrealized revenue, as well as the increase in wealth, of (usually) an individual. However, personal income tax (PIT) is usually levied on the receipts and accruals of revenue streams and the realized increases in personal wealth.

There are said to be broadly three variations of personal income tax systems, namely (i) comprehensive taxation (now the most common), (ii) dual-system taxation (found in the Nordic countries), and (iii) flat-rate rate taxation (such as in Estonia, for example). Each has its advantages and disadvantages, and trends towards or away from any of these models often depend on the economic circumstances of the specific country. No national system of personal income taxation in any of the above forms exists in a pure manner.

A comprehensive PIT system aggregates all income streams (including realized growth of wealth) into a single calculation, which is generally taxed according to a progressive tax table (this concept of income is said to be based on the Haig–Simons definition of income). This is to be distinguished from dual-system taxation, in which income streams such as wages and investment income are aggregated and taxed at a progressive rate, but realized growth in capital is taxed at a separate (and often flat) rate. Others separate active income from passive income and often the realized capital growth. Some systems historically categorized income into “schedules”, often each with different rates (the so-called “schedular system”), but these have been largely replaced by the more contemporary systems listed above. Finally, a flat tax system imposes a flat rate on all the income streams (including realized increase in wealth) and may or may not distinguish among them.

The critical differences in the design of each of these PIT systems usually stem from two main considerations: First, who is to be taxed – this consideration has to take into account not only the population to be taxed

but also the proportion of tax to be borne by that population. Second, what income is to be taxed – this is more difficult than the question reads. In this second category, the core income streams of wages, business income, and passive income from capital (including interest, dividends, and capital gains) need to be considered, i.e. how each form of income will be taxed in the system. Business incomes are particularly important in the context of entrepreneurs (sole proprietors) versus the taxation of incorporated forms of business entities (usually taxed as a corporate income tax). Whether the system seeks to not distinguish between these forms of business and tax them on the same basis or to rather distinguish between them depends on the policy goal of the country. For example, the country may wish business to be conducted through formal entities as a way of regulating business, and so distinguish the taxation (with a higher tax) of entrepreneurs, or it may seek to prevent arbitrage between the taxation of the two types of taxation for business income.

Each of the key considerations above should also be contextualized in the political and economic climate of the country seeking to introduce or reform its PIT system and be firmly rooted in the intended purpose of PIT within the suite of taxes in that particular country. From these core elements of the PIT system, the other critical features follow, such as administration and prevention of avoidance and evasion, among others.

It is therefore critical to understand that, despite there being many common features in PIT systems, there are just as many differences. All these features and factors need to be taken into account. There is no one-size-fits-all approach to PIT.

1.1.2. Are social security contributions part of the personal income tax system?

Social security contributions are often included, in practice, in the consideration of any PIT system. However, comparative studies of PIT systems may exclude social security systems from their scope to isolate the effects of the taxation levied outside of social security contributions. The reason for its inclusion in some comparative studies scope is that (usually) the collections of social security systems are tied to the collection of wage taxes from employers. When reading such comparative studies concerning the percentage contribution that PIT makes to the total tax revenue or relative to the gross domestic product (GDP) of a country, it should first be

established whether the values being compared are inclusive or exclusion of social security contributions.

In countries where social security systems are well developed, there is an observable historical shift from high PIT to a broadening of the base and reduction of PIT rates in favour of higher contributions to social security systems. It is, therefore, important to consider the social security system as integral to the PIT system. However, there remains a clear theoretical distinction between PIT and social security systems. Primarily, PIT systems are paid into a general revenue pool to fund general government expenditure. That is, the tax is not driven towards a particular benefit for society, whereas social security system contributions are geared to a specific purpose, to fund the benefits paid out (that is, the contributions are linked to the benefits received/receivable). This distinction can become less clear in practical terms depending on the design of the social security system.

1.2. History and evolution of personal income tax systems

1.2.1. A (very) brief history of personal income tax

History reveals that PIT had a very chequered experience during the 18th and 19th centuries, despite even earlier introductions in other forms, before featuring as a more permanent element in most tax systems. Prior to the introduction of various forms of income tax, revenues were largely derived from forms of expenditure (such as tariffs and customs); taxes on property (land taxes); and, at times, a poll tax, usually where property was insufficient. The more a person spent (or owned in property), the more of a contribution would be made to the revenue of the country. Naturally, such forms of tax are reliant on the amount spent or consumed. Any person wishing to avoid taxation simply had to spend less. No taxation was effectively levied on savings or unspent wealth accumulation. Some forms of taxation were, at times, applied to outward displays of wealth: examples include the number of carriages, windows on houses, and servants.

PIT was usually introduced with the stated aim of it being a temporary measure (to fill a “revenue hole”). The most regular appearance (at least within Europe) was to fund governments during times of war. As a “temporary measure”, the taxes were of necessity repealed after the cause for which the tax was introduced ended. As a successful temporary revenue boost during various European (and other) wars, it was later introduced in peace times, as revenues from the traditional forms of revenue collection began to

dwindle under the pressures of demands for free trade and the burden that tariffs placed on persons with low income and retailers. The repeated introduction of an income tax eventually turned public opinion from resistance (after the cause which resulted in its introduction being concluded) to one of reluctant resignation to the inevitable permanent introduction.

The appearance of income taxes in European countries at war also caused the spread of the notion of income tax, as an emergency levy, to the various colonies of those European countries. The use of income taxes survived, at times, in colonies despite repeal in the “mother” country. In some cases, the income taxes, sometimes derived from repealed forms of income tax in the mother country, were eventually repealed in the colonies for political and other reasons. However, the income taxes returned in the early 20th century as colonies developed their own income taxes, inspired by the old colonial income taxes and developments elsewhere.

Income taxes initially levied were often mistrusted and disputed. First, it was a sea change from the forms of taxation that were levied at the time, which were seen as “voluntary” as they were based on expenditure. Second, it was already recognized on the introduction of the first income taxes that the nature of the tax demanded a more investigatory approach to verifying the returns and the subsequent levying of taxation. It was broadly acknowledged that evasion of the tax would be commonplace. Efforts to curb such actions from the taxpayers included the introduction of tax secrecy and self-assessment, with enquiry only being made where the assessment was considered inaccurate by the tax commissioners. However, the tax remained criticized as a violation of the principles of good taxation by Adam Smith and other economic literature of the time (18th and 19th centuries). There was also concern about the risk of varied assessments depending on the (mood of the) tax commissioner making the assessment. The income tax was, therefore, seen as uncertain and (potentially) arbitrary. Third, in the construction of the first income taxes, there was much debate about whether the tax should be progressive (i.e. the marginal rates increase as taxable amounts increase) or proportional (i.e. the levying of a flat rate, subject usually to an initial exemption of income) in nature (although, at times, the terms were conflated). Certainly, in the United Kingdom, despite a graduated scale being introduced, progressivity was attached to an attempt to distribute the tax burden of funding the wars across the social classes. The parliamentarians who introduced the tax vehemently opposed its use as a redistributive tool for correcting societal inequalities (that is, taxing the wealthy more to redistribute the taxes to the poor through government initiatives).

To overcome some of the challenges of correctly identifying the income (removing the arbitrariness of some assessments) and levying the appropriate tax, a schedular system was introduced, whereby certain income streams were identified and tax was largely to be withheld at source. That is, the payor had the obligation to withhold and remit the tax on behalf of the taxpayer. This schedular system and withholding at source sought to overcome the uncertainty of the tax and substantially to prevent evasion of the tax (caused in part by the knowledge of all the income of a single taxpayer being known by a single assessor). It also came with the limitation that not all forms of income were necessarily listed. The early PIT schedules featured differing rates for different forms of income, which created problems of arbitrage, misclassification, and economic distortion. These systems also included numerous exemptions and credits. These exemptions and credits were aimed at offsetting the impact on lower-income households, reflected the impact of political forces, and attempted to overcome the difficulty of applying the tax in certain contexts. The schedular systems have since given way to global comprehensive PIT, but no system is purely a comprehensive one. Most current PIT systems, e.g. the dual-base systems in the Nordic countries, include schedular elements. Other systems, such as the United Kingdom's, have also moved to a comprehensive basis but retain split treatment between income and capital gains as well as differentiating in terms of rate structure.

A final challenge identified during the development of the PIT systems was whether to levy taxation on foreigners earning income in the country. The strong initial view was that, as foreigners were not represented in Parliament, no taxation could be levied on such persons (the adage of no taxation without representation).

Despite all these challenges, the contribution of PIT relative to GDP continued to grow.

1.2.2. How has personal income tax evolved?

When personal income taxes were initially introduced, the rate at which the tax was graduated was in few increments and topped at low percentages (usually not much more than 10%) at the beginning of the 20th century. This was combined with (generally) a small tax base on which such taxes would be levied. Thresholds before income tax was to be levied were set high, further narrowing the base. Income taxes were also strongly perceived as highly confiscatory by the taxpayers and easily avoided or evaded.

As the permanence of PIT was established and government services were expanded, the demand for revenue for the government grew – as did the rate at which taxes were levied. Coupled with the increase in rates (and progression bands) was the increasing complexity of administering and applying the tax. As tax administrations improved, the tax base was increasingly broadened through varied tax bands and lower thresholds to enter the system. This provided for increasing revenue for governments.

The short period of rapidly increasing marginal rates (between 1910 and 1930 for developed countries), with the highest rates regularly higher than 60% and in some cases as high as 90%, was followed by a longer period of declining rates. The period of decline was a global phenomenon from the 1980s, ending currently at about half the high marginal rates faced before. Marginal rates declined more rapidly for high-income earners than for lower-income earners. This may have been in response to the concern as shared when income taxes were first introduced, namely the loss of high-net-worth individuals to other countries by virtue of the high rates of taxation. Thus, some circumstantial evidence exists in the literature to suggest something of a race to the bottom for the PIT rates, as the rapid decline started in high-income countries and eventually passed to low-income countries (following the historical trends of the introduction of the tax at the outset). Along with the declining rates, the number of increments within the rate structure also flattened, with less frequent changes to the marginal rates applied to those increments.

The flattening of the rate structure may also be related to the growth of social security systems. Such social security systems provide for economic transfers (redistribution), so the progressivity of the PIT has become, perhaps, less necessary. Some countries began to favour a flat rate for PIT (that is, a proportional rate rather than progressive rates), especially when combined with social security contributions. Other changes to PIT were reform changes (substantive changes to the PIT system) reacting to changes in the economy. For example, as economies became more industrialized and tax administrations improved, the tax bases were broadened, such that more eligible persons reached the tax thresholds; efficient collections were put in place, often at source to prevent evasion; and reforms addressed some of the distortions in the tax system, especially those created by treating different forms of income differently.

With the changes to tax rates also came annual adjustments (in most countries) for inflation. This occurred less frequently in low-income countries, causing “bracket creep” (where the real value of money declines and the

effective tax increases as the exemptions and brackets provide less relief from inflation). It is evident that changes to personal income taxes are still made regularly, even outside the inflationary changes made to tax rates and thresholds. This brings into question the ability of the tax to retain a level of certainty sufficient for a taxpayer in line with good principles of taxation.

Outside of the extensive issues around the choice and progression of the rates, critical in the evolution of these systems was the treatment of the various forms of income. As could be seen in section 1.1., three main systems emerged being comprehensive, dual-system, and (later) flat rate systems (which might consolidate income as for the comprehensive system or separate the incomes into categories as for the dual system).

1.3. Historic and current justification for personal income tax and variations caused by country economic development

1.3.1. Historical reasons for the introduction of personal income tax

Apart from the brief historical analysis given in section 1.2., event analyses for the introduction of income taxes show not only that government spending pressures are a factor in the introduction of income taxes but also that declining tax collection costs play a role in influencing the introduction of PIT. There is even evidence that improved democratic systems (i.e. increasing the voting base), at certain thresholds, increase the likelihood of the introduction of improved systems. Lessons learned from a neighbouring country's introduction of PIT have also played some part.

Yet some countries have, in the past, elected not to introduce personal income taxes. The reasons vary for such a policy choice. An example would be oil-rich and exporting nations deriving the revenue needed to run the country by selling their natural resources. However, such countries are susceptible to sudden swings in revenue, as natural resource prices can vary significantly. Further, in such countries, services to citizens and residents are usually funded from the government revenue from the sale of natural resources (although some still have social security contributions paid by employers based on payroll).

1.3.2. Differences between developed and developing countries in personal income tax systems

PIT systems differ not only in design but also in application based on the country's level of economic development. Various factors impact the design of PIT systems. Some of these are non-tax factors, such as poverty levels, level of formalization of the economy, level of literacy, levels of democracy and levels of company payroll. Other factors relate to taxation and the global economic situation in general, such as the size of the middle class, the existence of social security systems, and reliance on other forms of taxation revenue. But, as will be seen in section 1.3.3., that tide may be turning.

Despite the significant decline in global PIT rates since the 1980s, the impact of the PIT rate schedule is very different across countries due to the levels of inequality. The level of income to which the highest rate of PIT applies in a country relative to the per-capita GDP will vary significantly and points to the enormous differences in taxable populations and tax bases between developed and developing countries. For example, it is typical in developed countries for an individual with income at four times the per-capita level to reach the maximum marginal tax rate; whereas, in developing countries, that multiple is much higher. It is further evident that changes in the PIT systems in developing countries seem to follow those of developed countries but with a time lag. Whether this points to tax competition issues or broader global economic issues is not clear. Certainly, the level of economic development in the country plays a role.

The presence of large informal sectors causes a significant difference in the tax systems of developed versus developing countries. These large informal sectors also make those subject to PIT in developing countries more sensitive to changes in the PIT system. Without strong tax administrations supporting taxpayer education and compliance, this simply leads to avoidance or evasion of the PIT.

The development of PIT systems reflects the contrast between the stages of development of PIT in developed countries, emerging economies, and low-income developing countries. Developed countries and some developing countries have mature PIT systems. In such systems, the contribution of PIT to the general tax revenue has reached a steady proportion that, in recent times, has slightly decreased to approximately 25%, excluding social security contributions). It should be noted that such approximations aggregate many different countries with different systems. For example, within the OECD countries (which average 25% contribution from PIT),

outliers include Denmark, with a contribution of approximately 52%, versus the Czech Republic, at around 9%. Developed economies tend to have large taxpaying middle classes, leading to broad tax bases and flatter rate structures. The progressivity of the PIT has also decreased over time in developed countries, especially as social security has risen. The collection is efficient, so the contribution of PIT is sensitive to tax rate changes (i.e. raising the rate is matched with an increase in revenue). Social security contributions contribute (based on an OECD average) about as much to total tax revenue as PIT.

In contrast, the proportion of tax revenue from PIT in emerging economies and low-income developing countries is on the rise: currently at approximately 13%-16% of the tax revenue collected, excluding social security contributions, of which there are often little to none. Again, the aggregation does not paint a full picture. PIT as a percentage of total tax revenue in Costa Rica and Colombia was around 6.5% in 2021, with Costa Rica growing from 0.4% in 2003, but with Mexico nearer to the OECD average at 21.5% and still showing growth. Some of the increase can be attributed to an increase in industrialization (and a move away from agriculture) and a growing formal labour market, both in the public and private sectors, accompanied by a reduction in self-employment. However, high entry thresholds to PIT and lowering of maximum rates add to the low tax base on which the tax is levied. As a result of this narrow base, the overall contribution of PIT remains low, despite potentially high progressivity in the PIT (with those within the small contributing base carrying a large burden to support the poor). The contribution from PIT is further eroded by exemptions, deductions and allowances granted, as well as some distortive effects arising from labour income and other forms of personal income (including income from self-employment) being treated differently. The lower contribution of PIT in the mix of taxes for emerging economies and lower-income developing countries is exacerbated by the reliance on other forms of taxation, usually indirect taxes and greater reliance on corporate tax than OECD countries. In general, these factors can render the PIT insufficiently progressive in relation to the system as a whole, in that its redistributive powers are limited.

Weak tax administrations significantly reduce the effectiveness of the PIT. This is particularly prevalent in low-income developing countries. Such weak administrations also lead to higher levels of avoidance and evasion.

1.3.3. Should personal income tax be featured in a tax system?

In relatively few countries, PIT plays little or no role in revenue generation. This is usually in resource-rich countries, where revenue generation at the national level is through sales of natural resources by the government rather than raising revenue from its residents. However, various economic crises and the volatility of the prices of natural resources have placed some countries at risk, and there may be a need to diversify the revenue sources for the government. In the context of the Middle East and North Africa (MENA) region, where the use of PIT (excluding social security) in oil-exporting countries was scarce, reasons to introduce PIT mirror the historical reasons for the introduction of PIT – even if framed in a regional context. The first reason is budgetary pressures. In this context, the budget pressures are caused by the need for increased social spending beyond that which social security contributions can provide and to mitigate against the risks associated with most revenues coming from oil in the light of volatile prices and climate pressures. Second, improved tax administration has played a part in considering the introduction of PIT. The introduction of VAT in the Gulf Cooperation Council (GCC) has generated the necessary administrative efficiencies and capacities relevant to the introduction of PIT (the improvement of such systems). However, some of the proposed reasons for considering the introduction of PIT in this region can be considered more “modern” reasons for the introduction, i.e. such reasons were not contemplated in the early versions of personal income taxation. These include the need to address income and wealth inequality and to address the role that PIT can play in making governments more transparent and accountable to their residents (the “state-building” reason).

Much literature refers to PIT as a “progressive” tax. This is usually in relation to the manner in which the tax rates rise progressively. However, in fact, the measure of whether the tax is progressive is the contribution it makes to redistribution. This can be seen, for example, in the way in which the revenue raised by PIT is directed to spending programmes to alleviate poverty and inequality.

1.4. Fundamental principles of personal income tax

1.4.1. What are the fundamental principles within a personal income tax system?

Any PIT system should be principle based and consider key aspects of fairness (including the ability to pay), efficiency, administrability and effectiveness. Moreover, in designing any tax rules, the legislator should observe some key principles, such as equity and simplicity.

Tax rules should respect the equity principle. Equity covers the ability to pay, including the concepts of horizontal and vertical equity.

Horizontal equity, which requires that taxpayers in similar “income” positions are treated equally, restricts policy choices. For instance, most PIT systems distinguish between the taxation of labour income and of capital. Such differentiation, insofar as granting a privileged treatment to one, may amount to an erosion of the concept of horizontal equity if it is not properly justified by other constitutional considerations, such as efficiency in tax collection. Moreover, as taxation techniques and technology evolve, some considerations may not justify such erosion of horizontal equity. Horizontal equity is often further eroded by schedular forms of taxation distinguishing between various income types and levying differing rates to different forms of income. If the PIT system categorizes persons differently and excludes certain persons from the system, further distortions may be introduced.

Vertical equity requires taxpayers with different economic conditions to contribute differently in proportion to such differences. Normally, this is achieved by several measures, such as the recognition of a minimum exemption (i.e. an amount of income that is required by anyone to pay for basic or essential needs and that, for that reason, should not be subject to taxation), objective exemptions of certain items of income, or even a system of progressive rates. Even with a flattening of tax rates within PIT, vertical equity is generally retained as higher taxes are levied on higher income. As considered above (*see* section 1.3.), PIT within a comprehensive income tax system is generally used to achieve distributive justice, usually through progressivity with a focus on effective redistribution.

PIT often works with a social security system that facilitates, to some extent, economic transfers between those in a position to contribute to the system and those who draw from it, which may influence the progressivity of the system. The progressivity of personal income taxes should also be



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