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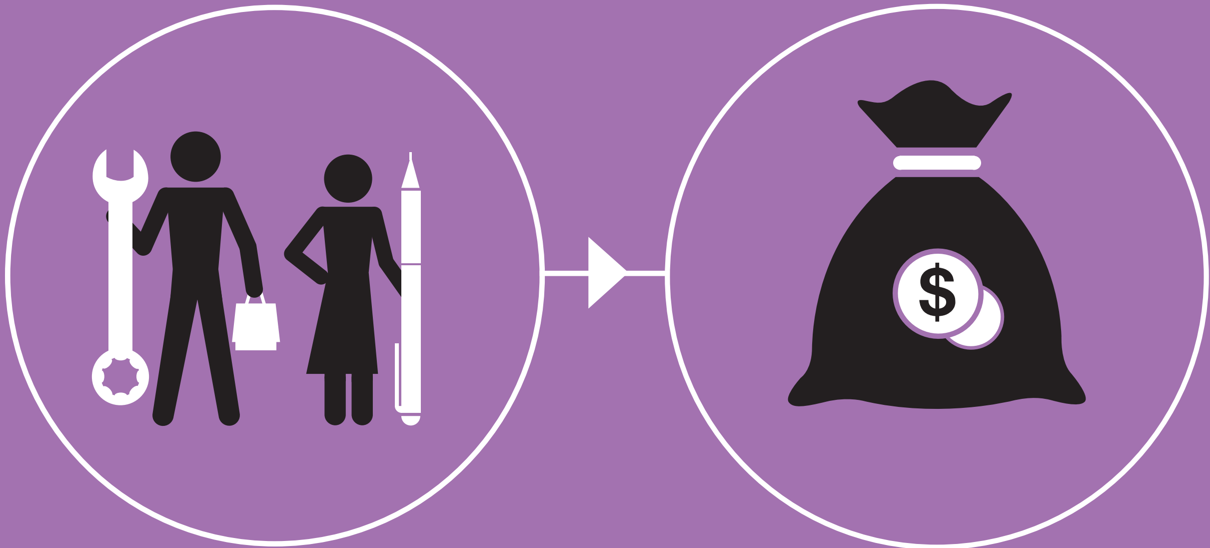
ActionAid International Briefing

Personal Income Tax (PIT)

Progressive Taxation Briefing



What is Personal Income Tax?

Personal Income Tax (PIT) is a direct tax levied on personal income including wages and salaries, director's fees, dividends, royalties and rental income, amongst others. PIT is paid by resident and non-resident individuals once they engage in taxable or income-generating activities in the country in question. PIT rates may either be flat or graduated, meaning that the tax rate increases as taxable income increases – those earning more pay a higher proportion of their earnings towards taxes. In the graduated approach, which is the most commonly used, tax rates are based on the income bracket of a tax payer. Individuals are taxed on income earned in an accounting period, referred to as the year of assessment – usually a calendar year.

Payroll deductions, called Pay as you Earn (PAYE) in many countries, are used to deduct tax from wages before they are paid to employees, and are mandatory in the formal sector of most countries. But these generally do not cover other kinds of income such as dividends, or income from self-employed people.

How can PIT be made more progressive?

PIT calculated on a graduated scale is considered one of the more progressive taxes in common use. For a tax that directly affects the amount of income that individuals can keep, it is imperative to ensure that taxation is designed fairly. A flat rate PIT is likely to result in richer taxpayers, who have a greater ability to pay, contributing relatively less than those with less ability to pay. For example, in Russia, residents incur PIT at a flat rate of 13% for all types of income (excluding income from interest and winnings

including gambling and lotteries, which fall under a different tax regime). While the risk of regressive outcomes from a flat rate may be at least partially mitigated by introducing allowances and deductions for low income earners, the risk of wealthy individuals contributing disproportionately small amounts remains.

Policymakers may opt to exempt certain amounts of income from tax. The most common form of an exempt amount is the threshold for taxable income. For example, in South Africa, where PIT rates range from 18% to 45%, annual incomes below US$5,599 (with higher amounts for those aged over 65) are exempt from PIT. The exempted amount is often referred to as the PIT *threshold.*

Applicable allowances (such as the married person's allowance) and deductions (such as mortgage interest payments or health insurance) also need to be taken into account to determine the amount of income that will be subject to tax.[1] This means that such allowances and deductions will be subtracted from overall income, prior to being subjected to tax. Allowances and deductions are often adopted by policymakers to encourage savings and investments, or to provide an indirect subsidy for families with children and low-income households. In the UK, one of the objectives of the family allowance, first introduced in 1946, was to encourage families to keep children in school.[2]

Tax credits, on the other hand, are specified amounts deducted from the amount of tax owed to the revenue authority. The result is an increase in the actual income available to the taxpayer. Tax credits may be made available to low income earners, people with disabilities, and people caring for children or the elderly. Alternatively, tax credits may be introduced to encourage societal goods such as saving for retirement (social security) or the use of green energy.

Tax allowances and credits may not reach all low income households and sometimes end up benefiting wealthy households more, particularly when there are no caps on the income classes entitled to the allowances; therefore allowances and other tax benefits should be capped at an appropriate income level based on the national context. For example, in the UK, the personal allowance – or the amount of income on which an individual is not required to pay tax –gradually decreases for net income above £100,000 and reaches zero where net income amounts to £123,700 or above.

PIT, Gender and Income Inequality

Personal income taxes are an important means of raising revenue progressively, provided that: a) the threshold exempts poor people; b) there are higher rates for higher income groups; c) all relevant forms of personal income are captured within the PIT regime and compliance maintained; and d) allowances or deductions do not disproportionately benefit higher earners.[3] PIT should also be examined based on how well it promotes the achievement of substantive gender equality.[4] Tax systems can contain implicit and explicit assumptions about women's roles in society.[5] Explicit bias, such as provisions that treat men and women differently, is no longer common.[6] Implicit bias arises where tax structures appear to treat men and women equally, but have an unequal impact because of, for instance, income or ownership patterns between the two groups. For example, joint filing by married couples, though it may appear to result in an overall financial gain for the household, often results in a higher marginal tax rate for women's income and might affect their decisions around participation in formal labor markets.[7]

Allowances and deductions based on income tax collected through payroll deductions may also work against those whose income is irregular, informal or unrecognised – which is more frequently the case for women than it is for men.[8] In developing countries, women are less likely to be in the labour force, and if they are, they are more likely to be in the informal sector.[9] Often the additional obligations of VAT and informal sector taxation[10] result in a comparatively disproportionate contribution to tax by women whose income is irregular, informal or unrecognised, while they cannot access e.g. tax credits for childcare.

In Morocco, tax credits and allowances for dependents are automatically given to men[11] even where women earn more than men, and women can only claim them if they can prove that they are dependent on the woman's income.

A well-designed PIT system can help redistribute income and redress women's socio-economic disadvantage by guaranteeing that women and marginalised groups are not contributing disproportionately.[12] In addition, governments may opt to introduce specified rebates for women under the

PIT allowance system, similar to the 10% rebate on income tax paid by women who do not hold couple status in Nepal.[13]

Direct taxes such as PIT are under-utilised and under-enforced in most developing countries,[14] which have been increasingly reliant on consumption taxes such as VAT – considered to be income, and gender, regressive.[15]

PIT Compliance

No matter how progressive the PIT system structure, low compliance by high net worth individuals (HNWIs) can result in regressive outcomes. HNWIs present tax administrations with key challenges, including their ability to access tax dodging schemes to avoid paying taxes, and the impact of their compliance behaviour on the overall integrity of the tax system.[16] By taking advantage of tax dodging schemes – or even evading their obligations by virtue of their political or elite status – in most countries HNWIs are able to avoid contributing to PIT, defeating the original objective of a progressive PIT: that those who earn more, pay more.

In Uganda, research carried out by the International Centre for Tax and Development examining why wealthy individuals are under-taxed, revealed that problems arose from: the Uganda Revenue Authority's (URA) overall focus on companies and employees; the political influence of HNWIs, most of whom tended to also be politicians or powerful business people; and the lack of information sharing between departments of the URA, between the URA and other government units, and the limited capacity to review that information.[17] These challenges meant that much HNWI income was not subject to PIT, and information about their income and assets escaped the automated systems.

To try and deal with the non-compliance of HNWIs, in 2015 the URA established a HNWI unit as part of the Large Taxpayer Office in the Domestic Taxes Department.[18] The HNWI unit generated a list of potential HNWIs, used the URA databases to track the economic transactions of these individuals, and set up appointments with them to discuss their tax affairs. The HNWI unit took a number of actions to better control and support wealthy individuals, and introduced policies to encourage political candidates to file their returns. They now maintain a register of wealthy individuals, and the number of HNWIs filing increased from 13% to 78% in the financial year 2015/16.[19] Based on Uganda's experience, it is evident that it is possible to improve the compliance of HNWIs through information collection and exchange, taxpayer education on rights and obligations, improved capacity to deal with these individuals, and collaboration with various units and government institutions.

Examples of Good and Bad Uses of PIT Systems

South Africa's PIT is considered to be highly progressive. Oxfam's Commitment to Reducing Inequality Index 2018, which includes an indicator evaluating the progressivity of the overall tax system with a strong component related to PIT rates, ranked South Africa first on the progressive tax policy indicator.[20] South Africa's PIT is based on graduated rates between 18% and 45% applicable to increasing annual income tax brackets, with a number of deductions and credits available. In 2018, tax revenue collection in South Africa was dominated by PIT at 38.1% of total collection, compared to VAT at 24.5%. PIT collection has continued to increase year on year.

In Nepal, PIT is based on a graduated scale and minimum threshold. The rates are 10%, 20% and the highest rate is 30%. An additional tax of 20% on wealthy individuals with any income that exceeds the highest threshold is also applicable. Nepal also provides a rebate of 10% of the tax liability to women who do not hold couple status on their income from employment, to further support female-led households.

Generally, there are few examples of bad uses of PIT. However, flat rate PITs have become increasingly common. In 2005 Romania introduced the flat tax, which resulted in a fall in personal income tax revenue.[21] A flat tax on its own may not appear to be regressive, however when considered in combination with other taxes such as excise, they may give rise to a regressive outcome particularly for poor people, and result in a greater benefit for high income earners.[22]

Recommendations

Governments should:

- *Ensure appropriate and graduated rates of tax applied to well-designed income bands that result in higher income earners contributing proportionately more in tax.*
- *Ensure appropriate PIT thresholds are adopted to protect poor people, women and marginalised groups.*
- *Strengthen progressivity by gradually limiting higher income earners' access to deductions, exemptions and allowances, and by adopting higher tax rates for higher income earners.*
- *Eliminate joint filing for married couples to prevent higher marginal tax rates for women that affect their decisions on labour participation.*
- *Annually review PIT thresholds and income brackets as well as the impact of inflation, in order to account for inflation and reinforce progressivity.*
- *Ensure that HNWIs do not take advantage of tax dodging schemes, by developing strong legislation and improving their compliance through taxpayer education, improved revenue authority capacity and collection of information.*

This is one of a series of briefings on Progressive Taxation published by ActionAid International in October 2018. You can find them at www.actionaid.org/taxpower

Endnotes

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ActionAid is a global movement of people working together to achieve greater human rights for all and defeat poverty. We believe people in poverty have the power within them to create change for themselves, their families and communities. ActionAid is a catalyst for that change.

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