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Dual income tax: A reform option for personal income tax in Turkey

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While several countries attempted to improve their income taxation model by adopting modified versions of DIT, Turkey has not implemented a pure DIT model but abolished the old return system and applied a final withholding tax on capital and interest incomes in 2006. Nonetheless, top marginal tax rate on earned income decreased from 55% in 1998 to 35% in 2010. A similar reduction was also observed with respect to the flat corporate tax rate, which was dropped off from 46% in 2000s to 20% in 2006 and the investment allowance was also abolished in that year. This is the first important step for introduction to pure DIT model, afterwards corporate tax rate should be reduced to 15% percent, which is equal to tax on capital incomes, thus capital incomes should be exempt from corporate income tax rate and the problems of double taxation of distributed dividends then will be solved. From this it may be concluded that the current personal income tax system in Turkey shares several features with the DIT model. The imposition of a pure DIT model in Turkey would improve income taxation and have a positive effect on Turkish economy.

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Introduction

As the world economy becomes progressively more mutually dependent with rapid globalization, a corresponding need surfaces for world countries to modify their national tax system fitting to international competitive circumstances (Boadway, 2005). Several OECD countries have reformed their personal income tax systems over the last three decades (OECD, 2006). However, no consensus has been achieved on what is and what should be the ideal personal income tax. Many countries have moved away from comprehensive personal income tax (CIT), which taxes all or most wages and capital incomes consistent with the same progressive rate schedule. Nevertheless, a number of alternative tax systems have been introduced in discrete states. The dual income tax system (DIT) established in early 1990 in Scandinavian countries is one of them, which taxes the capital income at low and proportional rates while labor income continues to be taxed at high and progressive rates (OECD, 2006).

The DIT model has influenced reform debates in many countries and has been embraced as a functional and reliable model of tax reform by OECD (Ganghof, 2005). While several countries attempted to improve their income taxation model by adopting modified versions of DIT, Turkey has not implemented a pure DIT model but abolished the old return system and applied a final withholding tax on capital and interest incomes in 2006. Nonetheless, top marginal tax rate on earned income decreased from 55% in 1998 to 35% in 2010 (Table 2). A similar reduction was also observed with respect to the flat corporate tax rate, which was dropped off from 46% in 2000s to 20% in 2006. From this it may be concluded that the current personal income tax system in Turkey shares several features with the DIT model.

The imposition of a pure DIT model in Turkey would improve income taxation and have a positive effect on Turkish economy. This concept can be clearly supported for Turkey since DIT model has been successfully implemented in all Scandinavian countries with the

exception of Denmark and in advanced OECD countries such as USA, Japan and Germany.

Reform models

a. Comprehensive income taxation (CIT) model

At a recent study, Sorensen defines ideal comprehensive income in the sense of Schanz-Haig-Simons (SHS) as the increase in the taxpayer's purchasing power over the tax period. Consequently, income should be measured in real terms, with appropriate inflation adjustment of nominal returns to capital, and all accrued real capital gains (losses) should be taxed (deducted), whether they have been realized or not (Sorensen, 2009).

As Ganghof said, the worldwide tax reform wave has started out as an attempt to approach real world income taxes closer to the CIT ideal. Tax reformers in Great Britain (1984), Australia (1985), New Zealand (1985-86), and the USA (1986) were very determined to apply CIT model in their countries. One fundamental proposal was to reduce top marginal tax rates to a stage at which all types of income could be taxed efficiently. The CIT approach is also meant to integrate corporate taxation as much as possible into personal income taxation by setting the corporate tax rate equal to the top marginal tax rate on personal incomes and giving shareholders a credit for taxes already paid at the corporate level (Ganghof, 2005).

Comprehensive annual income taxation systems are based on the principles of horizontal and vertical equity. With comprehensive annual income as the socially agreed indicator of ability to pay, CIT ensures horizontal equity. "Citizens with equal income are equally well off before tax and are liable to the same amount of income tax. Their gross income is cut by the same amount of money and they end up as equally well off after tax, exhibiting the same level of net income after tax. CIT also allows for suitably graduated annual tax payments to ensure vertical equity in line with socially agreed after tax distribution patterns" (Genser and Reutter, 2007, p.2). Moreover, CIT makes it more difficult to avoid taxes through income shifting.

The concept is robust against assignment problems of income to specific income categories¹. "Yet, in practice governments have been reluctant to tax unrealized capital gains and other forms of accrued income, because such income may be hard to measure and/or because the taxpayer may lack the liquidity needed to pay unrealized income. Hence, to the extent that capital gains are taxed at all, the tax is typically deferred until the time of realization, giving rise to the well lock-in effect and implying a tax preference for capital gains due to the benefit from tax deferral" (Sorensen, 2009, p.4). Besides, actually the returns to the nominal assets are rarely subject to regular alteration for inflation before being subject to tax, so the effective tax rate on real income may deviate substantially from the statutory tax rate (Sorensen, 2009).

A fundamental alternative to CIT model might be to implement an expenditure tax levied on the net cash flows of individual taxpayers and firms. In the late 1980s a Swedish government committee did in fact undertake a methodical study of the expenditure tax and conclude that serious technical problems would arise in the transition from income tax to expenditure tax. The Committee also found that expenditure tax principles would be difficult to coordinate with other countries relying on the conventional income tax. For reasons such as these, despite its theoretical qualities no OECD countries have seriously considered the introduction of an expenditure tax system (Sorensen, 2001; 2009).

¹ "The same marginal tax rate on all sources of income for a taxpayer implies a tax neutrality property. A given optimal income portfolio, characterized by the same rate of return for all income generating activities, will not be changed under a CIT model, as the net rate of return after tax is the same" (Genser and Reutter, 2007, p.2).

b. Dual income taxation (DIT) model

DIT is a scheduler tax regime dividing total income into capital and labor income and regards them as different tax bases. The tax base split offers an additional degree of freedom for tax policy, which can potentially be used to overcome some of the problems of CIT listed above. According to DIT model, capital income contains; dividends, interest incomes, rents, rental values as well as capital gains of real capital and property. By the way labor income consists of wages and salaries, non-monetary fringe benefits, pension payments, and social security transfers (Genser and Reutter, 2007).

Under the pure DIT system, the rate at which income from capital is generally taxed is equal to the lowest marginal rate at which labour income taxed. Two motives exist for this approach. “Firstly, income from capital has already been taxed when the latter was accumulated or subject to other taxes, e.g. dividends are issued after corporate tax has been paid on a company’s profits. Secondly, capital is globally more mobile than labour, thus more favorable treatment of income from capital discourages tax-motivated outflows of capital” (Randelovic, 2010, p.185). A flat capital income tax in the residency country will generally reduce the tax rate disparity between domestic and foreign source taxes, thereby limiting the incentive for capital flight. While it is true that tax harmonization is another way of fighting capital flight among EU countries, one has to keep in mind that DIT remains an attractive choice, because it also reduces capital flight incentives by channeling capital income to the residence country via Non-EU countries. Low capital income tax rates also alleviate the problem of negative after-tax returns on real assets under inflation (Genser and Reutter, 2007).

DIT is a quite attractive tax due to its administrative simplicity. Present personal income tax laws are too complicated and any tax reform should try to simplify tax laws so that laymen are also able to understand the tax code. In this context, a tax system is considered to be simple when the compliance and resource cost of filing return and collecting taxes are low. The DIT, which leaves no scope for arbitrage and avoids re-optimization of a firm’s decision in the existence of taxation, offers such administrative simplicity. Additionally, if the DIT applies a uniform proportional rate on all types of capital income, it is easier to administer since an assessment of capital income is not necessary any more. Furthermore, a separate source tax on dividends and capital gains need to be levied, if the tax rate on corporate profits and the capital income tax rate are equal and thus the profit payment is already taxed at firm stage (Radulescu, 2007).

DIT 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 direct investments. By the way of a move to DIT 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 tend over time to reduce the size of the informal economy (Bird and Zolt, 2008).

c. Compare of reform models: CIT versus DIT

Progressive income tax systems (CIT) are based on the principles of horizontal and vertical equity: taxpayers with the same level of income are taxed equally and taxpayers with higher incomes are taxed more heavily. Moreover, CIT make it more difficult to avoid taxes through income shifting, in many counties it is profitable to transform higher-taxed labour income into lower-taxed capital income. However, implementing a CIT system implies fairly high compliance and administrative costs, reduces tax compliance, tax revenues and impairs the efficiency and equity of the tax system. In addition, CIT systems discriminate against variable income. This may for example discourage seasonal work and reduce investment in human capital and the demand for risky assets (OECD, 2006).

So in practice no other advanced OECD country, with the exemption of New Zealand, followed the CIT model with similar consistency. All countries have special tax treatment for certain types of income (fringe benefits, owner-occupied housing, capital gains, pensions...) and many other countries levy social security contributions only on certain types of income (mainly labour income). By the way top personal income tax rate generally remained at much higher levels than in New Zealand. In 1996, roughly 10 years after the start of the tax reform wave, top marginal income tax rates averaged 52% in advanced OECD countries and none of these countries had a top rate below 40%. At the same time, policy makers in these countries remained unenthusiastic to integrate fully all types of capital income into the base of the progressive income tax. Thus important types of income (see above) continued to benefit from substantial tax privileges (Ganghof, 2005; OECD, 2006).

Unlike CIT, the DIT systems achieve horizontal equity in the taxation of capital and labour incomes. The lower tax rate on capital income also reduces the incentives for capital flight, tax avoidance and tax evasion. The focus on redistribution and the need to raise a sufficient amount of tax revenue explains progressive tax rate on labour income (OECD, 2006). This is seen as contrary to the so called “ability to pay” principle of taxation, even to social justice as a whole. “Be that as it may, the critics are missing the point of the tax reforms. These reforms are about making the country more attractive to business: For both domestic and foreign investors, it must be worthwhile once again to earn income and have it taxed in domestic country. Conversely, taxing capital income, which is internationally mobile, at high rates would do employees no good at all because the tax burden on capital would tend to be shifted to labour by paying employees less. In fact, DIT emphasizes the efficiency effects of tax reforms. DIT fits in seamlessly with a policy which focuses on growth and prosperity” (ZEW, 2008, p.9).

The strongest argument in favor of DIT relates to the fact that different forms of tax arbitrage can be avoided. Hence, under the CIT, it would be possible to accumulate the returns to debt-financed asset within a corporation subject to a lower corporate income tax or to deduct the interest payments against the higher personal tax rate. Moreover, if different taxpayers face different marginal tax rates, they could make use of tax differences to avoid taxation, for example via capital transfer amongst family members. A flat capital income tax equal to the corporate tax rate prevents such arbitrage opportunities. An additional advantage of DIT concerns the taxation of returns in inflationary phrases. Under a CIT regime, in most cases, the tax is levied on the taxpayer’s nominal instead of the real capital income, since inflation adjustment is not always undertaken. In contrast, the DIT imposes a lower rate on capital income and thus alleviates this taxation problem (Radulescu, 2007).

The “Achilles heel” of the DIT consists in the definition of labour income the form of imputed entrepreneurial salaries and capital income in personal ownership firms (Wiegard, 2005, p.56). In order to ensure an equal tax treatment of wage earners and the self-employed, the DIT system splits the income of the self-employed into a labour income component as a reward for work effort and a capital income component, which is the return to the savings inversed in the proprietorship. The part considered as labour income is taxed according to the progressive rate schedule. The part considered as capital income is taxed at the flat rate. This approach is also used to avoid active owners of closely held corporations transforming their highly-taxed wages into lower-taxed capital income (OECD, 2006).

Would a dual income tax be relevant for Turkey?

Although the DIT-proposal was not initially propagated by OECD countries, it proved to be a highly significant idea. After it had spread in Nordic countries¹, it greatly influenced

¹ Denmark was the first country to introduce the DIT, in 1987, but has subsequently moved to a hybrid between CIT and DIT (Sorensen, 2009, p.11).

policy debates all over the OECD world and was copied or adapted by many countries like Netherlands, Austria, Japan, and New Zealand, in which the renewal of the CIT-ideal begun. The DIT-proposal was also embraced by top level advisory councils and reform commissions in Germany, and recent reforms in USA were partly encouraged by the DIT model as well (Ganghof, 2005; Morinobu, 2004).

Scheduled tax structure which tax capital income at a low flat rate but keep the progressive tariff for personal income has influenced policy debates in Turkey too. Turkey has not introduced a fully-fledged DIT model but abolished the old return system and, introduced a final withholding tax on interest income and capital income in 2006. Labour income as well as earned business income subject to a progressive schedule. Additionally, top marginal tax rate on earned income has decreased from 55% in 1998 to 35% in 2010 (Table 2). A reduction is also observed with respect to flat corporate tax rate from 46% in 2000s to 20% in 2006 and the investment allowance¹ was also abolished in that year.

a. Tax burden in Turkey

There are large differences between OECD countries tax to GDP ratios. Denmark is confirmed as the OECD's highest-tax country, followed by Sweden, while Mexico and Turkey remain the lowest taxing countries, the latest OECD Revenue Statistics. Denmark's tax to GDP ratio stood at 48.9% in 2007, while Turkey's GDP was at 23.7% in 2007. The differences are significantly higher when social security contributions are included. In other words, Turkey collects less tax rather than its economic capability. By the way, the Turkish government reduced social assistance benefits and shifted the tax burden from direct to indirect taxation. The tax burden on indirect taxes, about 11 percent of GDP, is the same as OECD average, while tax burden on direct taxes is less than OECD average of about 15 percent of GDP, while Turkey's ratio was at 6% in 2009. The main reason of the lower total tax burden on direct taxes is inefficient taxation of income and earnings in Turkey. The other reason for this situation is an increase of informal economy. During the last ten years, the population has increased but the number of taxpayers has reduced. Alternatively, the share of agriculture to GDP is slightly higher than that of the OECD average, which was about 16% in 2008. So, in conclusion personal income tax base has shortened during these years.

Even with the recent reforms, the gap between total labour costs and take-home pay for low wage workers and workers with families in Turkey is among the highest of all European countries in the OECD (see Table 1). According to a study by World Bank this large tax wedge stems from high social insurance contributions (by employers and employees) and income taxes levied on workers and the lack of progressivity in the labour taxation system. "For a single worker in Turkey paid at the average wage or above, the size of this tax wedge - about 40% of gross wages- is in the middle range among OECD countries elsewhere in Europe. However, for low-wage workers and workers with dependents, Turkey's relative position worsens considerably. For example, the tax wedge for an employee with two children earning 67% of the average wage is higher than anywhere else in the OECD. This is because, unlike higher-income countries, Turkey's tax burden is not progressive but remains relatively constant regardless of income level or family situation. The "minimum living relief" introduced at the beginning of 2008 reducing the labour tax wedge² by 3 percentage points for workers earning 67% of the average wage and the employment package adopted in March 2008 reduced the wedge by

¹ There is no such a general investment allowance system in EU countries, which exempts 40% of investment expenditure from corporate earnings. Instead of this, EU countries have presented some regional and sectoral tax incentives to corporate investors. So, investment allowance doesn't prevent investments and should have some criteria which support new investment decisions in Turkey.

² Tax wedges measures the difference between labour costs to the employer and the net take-home pay of the employee. Table 1 also shows the parts of the wedges that are due to personal income taxes plus employee social security contributions.

an additional 2½ percentage points - applicable from end of 2008. Social security contributions were also reduced for the early years of employment of young and female workers in 2008, and to a more limited extent for all workers. The Treasury is temporarily paying the social security contributions of newly hired workers in 2009 for a period of 6-12 months” (World Bank, 2009, p.vii). Consequently tax burden on labour source was reduced extremely with this arrangement and Turkey was ranked 9th between OECD countries with 42.2% in 2007 (OECD, 2010, pp.148-149).

TABLE 1. COMPARING AVERAGE TAX WEDGES¹ IN TURKEY
WITH EUROPEAN COUNTRIES BY FAMILY TYPE AND WAGE LEVEL, 2004

Family type	Single No children			Single 2 children		Married 2 children		
Wage level ²	67	100	167	67	67-0	100-0	100-33	44-0
Turkey tax wedge (%), OECD methodology	41.8	42.7	44.4	41.8	42.7	42.2	42.2	41.3
Number of EU-15 countries with higher tax wedge	3	8	8	0	0	0	3	-
Number of EU-4 countries ³ with higher tax wedge	2	3	3	0	0	0	1	-
Turkey tax wedge (%), with consumption tax credit	39.0	40.0	41.5	39.0	38.3	38.7	39.2	35.3
Number of EU-15 countries with higher tax wedge	5	9	9	0	1	1	3	-
Number of “EU-4” countries ³ with higher tax wedge	3	4	4	0	0	1	2	-
Turkey tax wedge (%), with minimum living relief ⁴	38.18	40.28	43.10	37.03	37.44	39.03	39.90	32.57
Turkey tax wedge (%), 2008 (after intended reduction of social contributions) ⁴	35.50	37.71	40.66	34.33	33.60	36.42	37.32	29.67

Note: ¹ Income tax plus employee and employer contributions less cash benefits; consumption tax credit added for Turkey. ² Figure in this row indicates wage levels as a percent of average production wage. In the married families examples, wage levels for each adult are given (e.g., 67-0 means that primary earner has wages at 67 percent of average production wage and where another adult has no earnings). The last example (44-0) represents the case of a family with one minimum wage worker and non-earner. ³ Includes EU-10 (new accession) countries that are also OECD members - Czech Republic, Hungary, Poland, and Slovak Republic. ⁴ As of January 2008, the practice of “Minimum Living Relief” replaced the practice of “Special Expenditure Relief” in the Income Tax Law, which resulted in a decrease in the tax wedge. Furthermore, additional relief in the tax wedge was introduced after the 5 percent reduction in the social security contribution of employers that took effect in October 2008. The table above shows the tax wedges after the introduction of new practices, as calculated by the Government.

Source: World Bank (2009, p.3).

b. Taxation of earned incomes

Earned income consists mainly of pensions, salaries, wages and similar remuneration for work. Income from self-employment, trade and agriculture are also earned incomes. All forms of earned income tax are levied at a progressive rate. During 1963-1980 personal income tax tariff did not change, so was not indexed to inflation. Tax rate ranges from 40 to 75 in 1981 depending on earned income brackets. These are also the highest income tax rates of Turkish income tax history. After a time, income tax rates were reduced

swiftly and in the early 2006 tax rates were reduced to 15% for the first income bracket and to 35% in the highest tax brackets. Through, Turkey has ranked from 9th in 2002 to 19th in the present day, between the OECD countries according to the highest marginal income tax rate placement. These rates are almost comparable to the EU average of about 36%, but less than the Nordic countries, which adopted the DIT model, personal income tax rates (see table 5). Parallel with the decrease of tax rates, the number of tax brackets had slightly decreased from 10 in 1980 to 4 in 2006 (see Table 2). Now Turkey has a tax tariff with four tax bracket in 2010¹.

TABLE 2. PERSONNEL INCOME TAX SCHEDULE (EXCEPT WAGE AND SALARIES)

Years	Number of Brackets***	Minimum tax rates	Top marginal tax rates
1950-1957	7	15	45
1958-1961	10	15	60
1962	7	10	70
1963-1980	10	10	68
1981-1985	6	40	75
1986-1993	6	25	50
1994-1998*	7	25	55
1999-2004*	6	20	45
2005*	5	20	40
2006-2010**	4	15	35

Note:* Among 1/07/1998-31/12/1998 wages and salaries taxed a separate tax tariff which started from 20 % and ended at 45%. This rule endured during 1999 to 2005 and rates of nominal tariff decreased by five percent. **Separate taxation of wages and salaries was abolished in 2006. *** Since 2006 an increase in the third and fourth income scale which became 7 % and 8 %, respectively.

Source: <http://www.gib.gov.tr/index.php?id=1028>.

At the beginning of 1999, with the law of 4369, wages and salaries taxed on a separate tariff, which is 5% less than normal tax tariff, thus tax burden on labor income was reduced from about 50% to 42.7% in the first year of enforcement of the rules. However separate taxation of wages and salaries was abolished in 2006 with law of 5479 and all income derived from a different source had been taxed at a uniform tax tariff at the beginning of that year. After four years, in 2009, the Turkish Supreme Court abolished unique tax tariff enforcement and decreased top marginal tax rates from 35% to 27% for wage earners. These will be enforced in 2010 and will reduce only reduced tax burden on high wage owners. If the government supports the tax equality then there must be a revision of the tax rates for the low income groups.

c. Taxation of capital incomes

Turkey introduced a 15 percentage final withholding tax on interest income and capital income in 2006, which is very low compared with Nordic counties (Table 5). Tax on income from the capital paid at source represents an individual's final tax burden for this type of income. However, withholding tax rates on capital gains (such as government bonds and investment bonds, e.g.,) and interest incomes for foreign investors have been reduced from 10% to 0%, but the Turkish Supreme Court was abolished this application and applied the 0% tax rates also to the domestic investors, thereby the decision of Court appears to create an equal environment and fair justice among local and foreign investors

¹ As part of a trend towards "flatter taxes", many countries have reduced the number of tax brackets. This trend-also caused by the reduction in the top marginal income tax rates - has continued since 2000. The number of brackets in the personal income tax system in 2005 varies from just one rate in The Slovak Republic to sixteen in Luxemburg (OECD, 2006, p.3).

(Table 3). Yet this is very important tax privilege for foreign investors who want to invest in Turkish capital market.

The changes in the corporate income tax were no less dramatic. The statutory tax rate was reduced from 46% in 1980s to 20% in 2006. In order to maintain on unchanged level of revenue from the corporate tax, the rate deduction was combined with substantial broadening of the tax base. The investment allowance, introduced in the mid-1960s as the main tool of a countercyclical fiscal policy, was discontinued and replaced by reduced corporate tax system, in the 2009 with the law of 5838, article 9. Thus the tax burden on corporate earnings was reduced from 44% to 34% and Turkey has become an attractive center for Foreign Direct Investments (FDI).

TABLE 3. WITHHOLDING TAX RATE ON UNEARNED INCOMES IN TURKEY

Types of income	Withholding tax rate (%)	Return position	Deductions	Offsetting of losses
Capital gains on stock and bonds	Zero (0)	No return	-Commissions -Banking and insurance transactions tax	Deductible against income from same source of income during the following three months in a year
Interests on bonds and debentures	Zero (0)			
Deposit interest	15%			
Repurchase agreement (repo)	15%			
Dividends	15%			
Retirement pensions (ITC, 75/15- a, b, c)	15%, 10%, 5%			
Mutual funds	10%			
Distributed dividends (ITC, 75/ II-1, 2, 3), ITC 94/6-b, i, ii, iii	15%, 15%, 10%			

Source: http://www.gib.gov.tr/fileadmin/beyannamerehberi/2010_Gecici67.pdf.

TABLE 4. CORPORATE TAX RATES 1999-2009

Country	1 Jan. 99 (%)	1 Jan. 00 (%)	1 Jan. 01 (%)	1 Jan. 02 (%)	1 Jan. 03 (%)	1 Jan. 04 (%)	1 Jan. 05 (%)	1 Jan. 06 (%)	1 Jan. 07 (%)	1 Jan. 08 (%)	1 Jan. 09 (%)
Denmark	32	32	30	30	30	30	28	28	28	25	25
Finland	28	29	29	29	29	29	26	26	26	26	26
Norway	28	28	28	28	28	28	28	28	28	28	28
Sweden	28	28	28	28	28	28	28	28	28	28	26,3
Turkey	33	33	33	33	33	33	30	20	20	20	20
ASPAC	31.67	31.44	31.29	31.52	30.34	30.37	29.09	29.09	29.18	28.43	27.49
OECD	35.0	33.90	32.80	31.39	30.90	29.75	28.89	28.15	27.69	26.56	26.30
EU	34.12	32.83	31.05	30.00	28.81	27.47	25.34	25.01	24.22	23.22	23.22
Latin America	28.82	30.09	29.83	29.91	30.05	29.82	28.04	27.64	27.45	26.91	26.91

Source: KPMG (2009, pp.12-16).

Obviously, this increased Turkey from second in 2002 to the twenty-fifth in 2009 among OECD countries. Statutory corporate income tax rate is 20% in Turkey compared to 41% for OECD and Turkey has a lower corporate income tax rate compared to Scandinavian countries average which is applied DIT model. Currently, Turkey is the fifth country with lower tax rates among OECD countries (Table 4).

d. Moving Towards Dual Income Taxation in Turkey

Prior to the reform in 2006, Turkey applied a global income tax (CIT), according to which the taxpayers were taxed at a single progressive tax rate schedule for their global incomes. Taxpayers faced the same tax rate regardless of the source of income. There were many different reasons for the abolishment this model and the introduction of the basic principles of DIT.

TABLE 5. DUAL INCOME TAXATION IN THE NORDIC COUNTRIES AND TURKEY, 2008

	Turkey (2008)	Finland (2008)	Norway (2008)	Sweden (2008)
Personal tax rate on				
capital income	0.15	28	28	30
labor income	15-35	27-50	28-48	31.5-56.5
Offset of negative capital income	Deductible against income from same source of income during the following three months in a year	Deductible against positive capital income	Deductible against other income in the first tax bracket	Tax credit
Corporate income tax rate	20	26	28	28 ⁷
Integration of corporate and personal income tax	Corporate income is primarily taxed at the company level and dividends are subsequently taxed at the shareholder level.	Classical System (partial exemption): Quoted companies. Only 70 percent of dividends are taxed (as capital income) Unquoted companies. Dividends below imputed return on shares are exempt from personal tax; and only 70 percent of dividends above that limit are taxed (as labor income) ¹	Modified classical system: Only dividends and capital gains in excess of an imputed rate of return on shares are taxed (as capital income)	Classical system: Quoted companies. No integration Unquoted companies. Dividends and capital gains on unquoted shares are taxed at reduced rates (see notes 3 and 5)
Personal tax rate on:				
dividends	15 ⁸	19,6 (=0,7 x 28)	28 ²	30 ³
capital gains on shares	0 ⁹	28	28 ⁴	30 ⁵
Withholding tax rate on ⁶ :				
interest	15	28	28	30
dividends	15	19	0	30
Net wealth tax	No	0,9% (until 2006)	0,9% - 1,1%	01,5% (until 2007)

¹ 70 percent of dividends exceeding 90,000 euros but failing below the imputed return are taxed as capital income.

² Apply only to dividends in excess of an imputed rate of return on the shares. ³ For active owners of closely held companies, dividends below an imputed return are taxed at reduced rate of 20% while dividends above the imputed return are taxed as labor income. Dividends received by "passive" owner of unquoted companies are taxed at reduced rate of 25%. ⁴ Applies only to capital gains in excess of an imputed rate of return on shares. ⁵ For active owners of closely held companies, capital gains below an imputed return are taxed at reduced rate of 20% while gains above the imputed return are taxed as labor income. Gains realized by "passive" owner of unquoted companies are taxed at a reduced rate of 25%. ⁶ For domestic residents. ⁷ Corporation income tax rate was reduced to 26,3 % in Sweden at 2009.

⁸ Half of the dividends received by personal owners are exempt from personal income tax, while remaining dividends are taxed as personal income. Personal owners have a tax credit for paid at corporate level. ⁹ Foreign and domestic capital owners are taxed rate of 0% on their all types of capital gains.

Source: Sorensen (2009, p.11); Randelovic (2010, pp.190-191); http://www.gib.gov.tr/fileadmin/beyannamerehberi/2010_Gecici67.pdf).

As often mentioned, the problem with the old system was that it favored certain forms of capital income (such as governments bonds and debentures) through deductions or tax

exempts, leading to tax planning. The basic principle of horizontal equity demands that capital income of the same amount, although from different sources, should be taxed at the same rate. It was also considered that the Turkish tax system needed an internationally competitive model for taxation of individual. It was feared that the CIT would lead to the flight of capital from Turkey.

In Article 1 and 2 of the Income Tax Law (ITL), it is stated that income is the net amount of earnings and revenues acquired by legal persons in one calendar year and the earnings and revenues which are considered as income have been enumerated as follows:

1. Commercial earnings;
2. Agricultural earnings;
3. Wages and salaries;
4. Self-employment earnings;
5. Earnings from immovable property;
6. Capital earnings;
7. Other earnings and revenues.

According to this, the total income is divided into capital income and earned income. Earned income consists mainly of commercial and agricultural incomes, wages and salaries and income from profession and business. Nevertheless, earnings from immovable and movable property and other earnings and revenues are considered as capital income. From this, it may be concluded that the current personal income tax system in Turkey shares several features with the dual income tax model (Miles and Sorensen, 2006).

At the same time, significant differences in the tax treatment of labor and capital income would generate undesirable distortions especially taxation of income derived from self-employed persons in Turkey. This problem arises because self-employed persons derive income both from their work effort and from the investment savings. Therefore, one must determine a labor and a capital income component, each being in part very complicated to assess. In order to distinguish labor and capital income in practice, an "income spitting model" was constructed in Nordic countries. According to this model, the easier ways to determine the capital income component first by imputing a rate of return on equity and tax this calculated return as capital income at lower capital income tax rate and the difference between total business and imputed returns is classified as labor income (Radulescu, 2007; 2010).

According to a pure DIT model, i.e. wages were taxed at progressive tax rates, whereas income from capital was taxed at a flat rate equal to the lowest marginal labor tax rate and the rate of corporate income tax. After the latest tax reform, in 2006, income from capital is taxed at a flat tax rate of 15%, which is slightly lower than the top marginal tax rate of tax on labour (ranging from 15% to 35%). So, the lowest labour income and capital income in Turkey are taxed at the same tax rates. Besides, the corporate income tax rates are almost the same as the lowest labour income tax rate and the rate of capital income. Thus, Turkish personal income tax system retains elements of the DIT model, compared to the Scandinavian countries (Table 5). On the other hand, there is a double taxation problem of distributed dividends, so after time Turkey should solve this problem with time (Miles and Sorensen, 2006).

Conclusion

There are three approaches to taxing personal income. In practice no OECD country has fully implemented a comprehensive personal income tax system. The dual income tax system established in the early 1990s in Scandinavian countries taxes personal capital income at low and proportional rates while labour income continues to be taxed at high and progressive rates. More recently, flat tax proposals have been put high on the political

agenda¹. Among these models, DIT has been embraced as a useful and consistent model of tax reform by OECD (Ganghof, 2005).

Turkey did not introduce a fully-fledged DIT, but introduced a final withholding tax on interest income and capital income in 2006. Labour income as well as earned business income subject to a progressive schedule ranges from 15% to 35%. This is the first important step for introduction to pure DIT model, afterwards corporate tax rate should be reduced to 15% percent, which is equal to tax on capital incomes, thus capital incomes should be exempt from corporate income tax rate and the problems of double taxation of distributed dividends then will be solved.

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¹ The flat tax system levies a proportional (flat) tax rate on all net income (capital income, labour income, and other income minus all deductions). Wage and capital income are then taxed equally and the value of the tax allowances is independent of the income level. So, flat tax reforms mainly consist of two elements: reducing the tax rate schedule to a single rate and eliminating special tax relief, with the possible expectation of a basic allowance (OECD, 2006, pp.1-4).