

Personal Income Tax Policy Analysis: Albania vs. United States

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ABSTRACT: Personal income tax has become an important part of the Albania's revenue system. Revenue from personal income tax was more than 27.9 billion ALL for the year of 2011 which makes up a 3% increase when compared to the previous year. This paper compares and contrasts Albanian and American income tax systems by describing many similarities as well as distinctive characteristics that were found. Professor Agim Binaj of Agricultural University of Tirana highlights the need for a fair personal income tax reform in Albania. This paper concludes with recommendations and an agenda for future research on tax policy using lessons from the United States tax system.

Keywords: Individual income tax; tax system; revenue; uncollected taxes; fiscal reform

JEL Classifications: E62; H3

1. Introduction

Personal income tax is one of the major taxes used by both developed and undeveloped countries (Gruber, 2005; Heady, 2004). However, the concept of the personal income tax, or the individual income tax, was not introduced in Albania until the early 1990s. Personal income tax policy has gone through several series of reforms and it has become a progressively more important source of revenue and a policy instrument in Albania's fiscal system. Personal income tax revenues accounted for 9.4% of the total tax revenues in 2010 and 9.2% in 2011. Revenue from the personal income tax was more than 13 billion ALL for the first half of 2011, a 7% increase over the same period of the previous year. According to reports released from Ministry of Finance (2011), the income tax, including here the corporate income tax, accounted for 6.5% of total tax revenues in Albania and combined with the personal income tax, it made up more than 15% of total tax revenues in 2011. These statistics illustrate the growing importance of the personal income tax in Albania's revenue system.

The relative share of personal income tax to total tax revenues may seem small in Albania but this is normal for developing countries and in transition where the personal income makes up a very small share of revenue compared to developed countries. Given the important role of tax policy in macroeconomic management in Albania, a more recent discussion of the economic stimulus package might include possible initiatives to increase the threshold of taxable income. Recently there have been numerous publications focused on tax policy and fiscal reforms in developing countries (Goode, 1993; Heady, 2004) but comparative studies of tax policy and reforms in transition economies have been relatively limited.

The goal of this study is to contribute to the comparative literature on tax policy and fiscal administration with a main focus on income tax. Additionally, this study aims to provide Albanian, and similar developing countries, policy makers with some international experiences since

international practices of taxation have been usually used as a significant guidance for past reforms in Albania.

This article consists of five parts. The first part presents the history of the evolution of the current personal income tax system in Albania. The second part identifies the several similarities between the personal income tax systems in Albania and the United States. The third and the fourth part identify aspects of individual income tax policies of these two countries and their differences. The final part concludes the analysis by providing recommendations for improving the income tax system in Albania by integrating practical solutions learned from the modern American tax system.

2. The History of the Personal Income Tax System in Albania

Albania's use of the personal income tax can be traced back to Ottoman Regime in the late nineteenth century. However, the present version of the personal income tax in Albania did not come into existence until in the early 1990s, as before then Albania was a socialist country with a highly centralized and planned economy. Thus, the personal income tax is a relatively new policy instrument in Albania. Although the definition of income tax includes both the personal income tax and corporate income tax, and although they are related, this paper is focused mainly on the personal income tax. The law and regulations on the personal income tax in Albania have gone through several reforms over the past two decades. The following is a brief summary of the historical development of the personal income tax in Albania.

- o Albanian tax system historical development should be viewed in relation with the time and circumstances of the start of the new era of democracy and the change from a planned centralized economy into a free market one around the end of 1990. With the birth of the first enterprises began the establishment of tax administration structures. As a result of negotiations and cooperation with the World Bank and IMF, the first fiscal package was prepared and adopted during 1991, followed by more comprehensive tax legislation during 1992.
- o Albanian personal income tax policy was consolidated by Law No.7786, Dated 27.01.1994 "For personal income tax" according to which any person, citizen or alien, who earns income is liable to pay personal income tax, unless stated otherwise in the law. This law mainly was targeted to high-income foreign professionals working in Albania, as few Albanian citizens had incomes high enough to meet the threshold of 10001 ALL per month. This law stipulated taxes on personal income tax as progressive and was a major step towards a standardized, scientific, and rational personal income tax system.
- o The second phase of transition was accompanied by the modernization of existing tax legislation and efforts to modernize tax administration. As part of fiscal reform, the abovementioned law on personal income tax was revised and replaced by Law No. 8438, Dated 28.12.1998. This Law regulates relations arising in the field of personal income tax, corporate tax and withholding tax. This law also established a number of exceptions in connection with the corporate tax, violations and corresponding penalties.
- o In 2001, the lower threshold of taxable income was set to be above 14000 ALL per month. It is clear that the main concern underlying this reform was the wide disparity of income in Albania. The table of taxable income was changed according to amendments made by Law No.8841, Dated 11.12.2001 (General Directorate of Taxation).
- o Table of personal income tax has changed frequently since 1994, but without changing the essence of progressive taxation. From 2005 until 2007 the table consisted of the following indicators (General Directorate of Taxation).

Taxable income (per month)		Percentage
Above (LEK)	To (LEK)	
0	14000	+ 1% of the amount above 0
14000 +	40000	140 + 5% of the amount above 14000
40000 +	90000	1440+ 10% of the amount above 40000
90000 +	200000	6440+ 15% of the amount above 90000
200000 +	And more	22940 + 20% of the amount above 200000

- o From January 1st 2008, the proportional system of taxation on personal income, or else known as "the flat tax", entered fully into force according to the fiscal package adopted in 2007. The main change consisted of replacing the 5 income levels progressive taxation with single rate taxation, with tax rates of only 10%. The exception to this rule were only low wages, up to 30000 ALL from which the threshold from 0 to 10000 ALL are exempt from taxation while the difference up to 30000 ALL is taxed at 10%. All other categories of salaries over 30000 ALL will be taxed on all gross salary (without exclusion rate) by 10% (Ministry of Finance, 2008). The system of "flat tax" (compared with the progressive system) hurts individuals with low and medium personal income and favors individuals that gain more. Since individuals with low and medium income make up for the majority of both public and private sector, then their contribution to the state budget revenues is greater.
- o The last amendment to the personal income tax law was made by Law no. 20/2012, dated 01.03.2012 according to which all individuals that realize an annual gross income of 2 million ALL or more are bound to file their income tax return not later than 30th of April of the year following that tax period; also all individuals that fall below this amount can still file their tax return if they voluntarily choose to do so in case they want to benefit from it.

The development of personal income tax laws in Albania cannot be separated from the country's economic reforms. In fact, the privatization of the economy since the 1990s and the economic reforms have been accompanied by crucial changes in fiscal institutions and relations between the local and the central government. With the collapse of communism followed by the liberalization of the economy and opening to the western world, more of the population turned towards the private sector and became urban residents increasing so their personal income. These changes created both conditions and needs for the adoption of the personal income tax. On one hand, there were increasingly more wealthy individuals to tax as a result of the rapid growth of the private sector and personal wealth. On the other hand, the fast transformation of society and economy environment created the grounds for sudden income disparities which became an urgent issue for the Albanian government and the personal income tax became one of the main policy solutions.

3. Similarities

A number of similarities can be identified between the personal income tax systems in Albania and in the United States. First, the definition of personal income for tax purposes in Albania is similar to that of the United States. According to the General Directorate of Taxation (GDT), there are about 11 different broadly defined taxes in Albania, which constitute a complex taxation system. The current definition of personal income includes wages and other remuneration in connection with the current working relationship; the revenue derived from the profits of a partner or shareholder in a commercial company; the income from bank deposits or interest earned from securities; author's remuneration; emphyteusis income, debt and rent; income from the transfer of property; individual gains from games of chance and casinos; capital gains derived from the difference between shares sales and purchase price; other income sources in Albania but that do not appear in this section; taxable income earned during the tax period by the small businesses that have an annual turnover from 2-8 million ALL calculated as the difference between revenues and total recognized expenses; capital increase from outside resources that are not previously taxed, and are not accompanied by official documents proving the origin of these revenues. Likewise, a summary of taxable income on the W-2 form in the United States includes salaries, wages, tips from employment and from providing personal services, and interest income from savings. This form is one of the most important documents issued by the employer to taxpayers for tax purposes.

Another issue in common is the concern about tax evasion. Tax evasion is one of the problems related to tax compliance. Tax evasion is intentionally failing to pay owed tax liability (Rosen, 2005) and has become one of the greatest issues for many governments. In the United States, uncollected taxes are estimated as high as 3.3% of the U.S.GDP (Sheridan, 2012; IMF, 2011). In Albania, Law no.10418 dated 21.04.2011 foresees amnesty for a part of fiscal debt (unpaid taxes, penalties and fines) in the amount of 57.7 billion ALL which makes up 4% of the GDP (GDT,2011; Ministry of Finance, 2011). It is even more severe when considering the large scale of the informal economy in Albania that, according to the CIA world fact book of 2011, is estimated to be around 50% of GDP and also based

on cash transactions, vastly different from credit-card-based transactions in countries such as the United States. Albania has also yet to set an example of punishment over tax evasion. Along with tax evasion, a common issue for these two countries is the cost of tax compliance. Enforcement of laws and regulations governing the personal income tax is expensive for both countries as a considerable amount of manpower and money are spent on audits, investigations, and lawsuits.

Also, Albanian tax system currently includes 7 main categories of exemptions for personal income tax that are similar to the individual tax regulations of the United States. Though the specific definitions are different, treatment for at least one or two categories is in common between these two countries. For instance, insurance payments are exempted. The following section discusses further the differences related to this category by providing a comparison between the two countries.

Finally, even though the system of personal income tax in Albania, unlike the United States, is proportional, the general opinion is that the progressive system is expected to be restored due to open concern about growing income inequality. Fairness and impartiality are essential to the good functioning of the tax system that is why disparity in personal income has been a constant concern for Albania and the United States, although they are in different stages of economic development.

4. Characteristics of the Personal Income Tax System in Albania

The structure of the tax system and the reform program in Albania are obviously different from those of the United States. A number of distinctive characteristics define the present Albanian personal income tax system. First of all, the current system in Albania requires reporting or filing only those that make an annual gross income of 2 million ALL or more and voluntary reporting for the rest. The current system has been implemented mainly for urban residents and is not enforced in rural regions. In the United States, all residents, including foreign residents, are required to file a personal income tax return by April 15 each year.

Though both systems exempt certain categories of income from the personal income tax, Albanian exemptions have their unique aspects (see table below).

- a) Income received as a result of compulsory insurance of social security and healthcare scheme as well as economic aid to families and individuals with no income or low income as defined in relevant legislation;
- b) Students' scholarships;
- c) Compensation received for cases of illness or accidents, in accordance with the provisions of the legislation and the applicable legal provisions;
- d) Income earned, including income in the form of cash or not, by the owners as compensation for expropriation made by the state for public interests;
- e) Income exempt under international agreements ratified by the Parliament.
- f) Income received as a result of financial compensation to former owners and former political prisoners.
- g) Contributions made by the employer to the employees' life and health insurance.

Differences found between exemptions of both countries may be related to different histories and social and political systems in these two countries. For example the formula for calculating tax liabilities is the same for each type of income source in Albania. A flat tax of 10% is applied to each of the different categories of income. In contrast, the formula of the American system for individual tax income allows aggregation of all gross incomes for calculating tax liability and allows different tax levels for different level of income or different income categories.

A major difference between personal income tax systems is the administrative structure for personal income tax collection. The current tax administrative arrangement is a result of the 1994 fiscal reform, which split the revenue system into national and local subsystems resulting in two essential limitations. With new administrative structure, the tax system became more costly as it split in two separate sets of tax administration personnel, one for national and the other for local tax administration. Additionally, as the central government is expected to play a crucial role in income equalization, it has been pressed to generate more revenue from different resources. In this sense, fiscal policy in the Albanian context is affected by the rivalry between center and local governments

for revenue sources hence a merger of these two systems could eliminate unnecessary duplication of institutions and personnel and consequently inefficiencies. In the United States the taxation function is implemented into the finance or revenue department in all levels.

Albania is at a crossroad between the proportional and progressive tax system. Given the country's growing income disparities, it is expected that the current reform will impose more taxes on the upper levels. Horizontal equity for taxation means that people in similar positions pay similar taxes but horizontal equity is not a major issue since the number of available exemptions in Albania is relatively small. Albanian transactions are mostly conducted on a cash basis thus making them difficult to be caught by the current taxation system. This fact relates to the still young and under development formal sector which is typical of developing countries. As a result, the enforcement of taxation on these evasive transactions is quite a challenge for the Albanian government. Also due to the large rural population and lack of tax enforcement power in rural areas, collection of personal income tax becomes rather difficult.

Finally, Albania's revenue structure is characterized by a small proportion of personal income tax revenue compared to total tax revenue. This is not surprising for developing countries but it is significantly smaller when compared to the United States, where payroll taxes are the main of the federal government revenues.

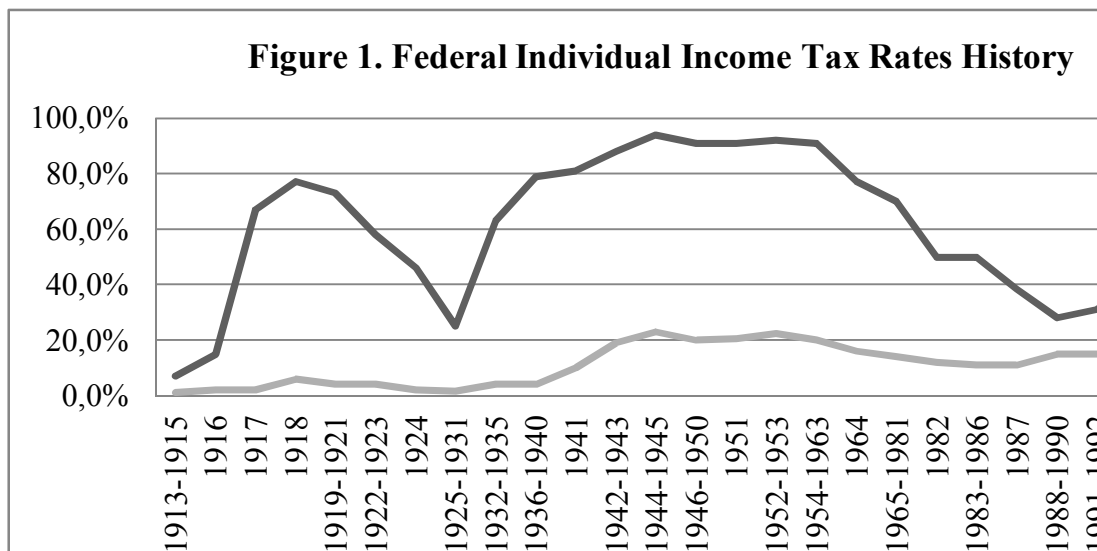
5. Characteristics of the Personal Income Tax System in U.S.A

The personal income tax system of the United States is more complex than Albanian tax system. The current concept of the federal personal income tax was first introduced in 1913 (Mikesell, 2007). Since then, there have been a number of modifications that were required by federal legislation and the personal income tax has grown in importance with time. For example, in 2005, the number of individual income tax returns made up around 59% all returns filed (IRS, 2005) while in 2011, there were more than 143 million individual income tax returns filed in the United States, accounting for 61.2% of all returns filed (IRS, 2011).

There are variations in personal income tax policy across the states and localities. All states except Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have state personal income taxes. Also only four states, Delaware, Montana, New Hampshire, and Oregon, do not have a sales tax. New Jersey has a sales tax except for clothing purchases that are exempt. These differences are related to the fact that federal, states, and local governments represent different levels of jurisdictions, and each one of them has its own tax enforcement power (Mikesell, 2007). The federal system allows state and local governments high levels of autonomy, which may explain the differences in the tax policies across states and local governments but despite the variations, all types of income taxes are directly deducted from payroll.

According to the data retrieved by Tax Foundation, the system in the United States started to become less progressive during the 1970s and 1980s, when the marginal tax rate for the top levels of income was reduced from 70% to 33% and it has shown a steadier trend in fluctuations since then (see figure 1).

However, there are parts of the graph that need further analysis. According to the chart above the top rate of the income tax started to increase in 1915 to reach 77% in 1918. This period covers World War I so it is fair to deduce that the increase happened to finance the war. The top marginal tax rate started to reduce since then and reached 24% in 1929. The rates started increasing again with the beginning of World War II, during which Congress introduced payroll withholding and quarterly tax payments. Top marginal tax rate stayed around 90% until 1964 when it finally dropped to 70%. The top marginal tax rate started decreasing since then to reach 28% in 1988. However, afterward, Congress increased the top marginal tax rate to 35% which has been the same since 2003 (Tax Foundation, 2011). These changes may be related to the belief that heavy taxation discourages investment and economic growth.



The current U.S. tax system allows a number of exemptions in order to adjust the personal income tax base. In US, many jurisdictions allow reduction of taxable income for certain categories of expenses not incurred. According to IRS (2011) these exemptions include expenses of more than 2% of adjusted gross income, medical expenses in excess of 7.5% of adjusted gross income, state and local income and property taxes, interest expense on certain home loans, gifts of money or property to qualifying charitable organizations, losses on non-income-producing property due to casualty or theft, contribution to certain retirement or health savings plans, and certain educational expenses. These exemptions were created so that American government can fulfill some important social goals for the American society. For example, the idea behind the exemption for health insurance payments was to encourage health coverage and the exemption of interest expense on home loans would serve as an incentive for people to become home owners.

However, tax exemptions in US give rise to several debatable issues. For example, questions arise about how to properly classify business costs as deductibles and whether charitable contributions are warranted. The Tax Reform Act of 1986 set a maximum of 2% for the business deductible amount to reduce system abuse. Indirectly, charitable donations provide an important contribution to society by encouraging donations to nonprofit organizations while they provide social services to society. The current debates on tax reform in the United States focus on simplification of the tax system. Democrats are in favor to higher taxes for the top income level while republicans support the idea of lower tax rates, as tax expense would distort government spending (Kogan, 1996).

6. Recommendations

Personal income tax reform of Albania has still a long way ahead in order to attain an optimal fiscal policy which would regulate the scope of the activities for each level of government (Gruber, 2005). For example, in Albania the central government needs to secure a set of revenue sources such as income tax and consumption tax in order to fulfill its role in social policy. Albania is building a more rational fiscal system. However; a number of important areas of tax administration can be improved. For example, a tax record based on individuals and a tracking system similar to that of the United States should be considered to facilitate the tax collection process and to encourage compliance.

Also, the need to turn from a flat to a progressive tax system is heavily discussed between professionals and politicians with valid arguments on each side. However, progressive taxes provide significant benefits to economically disadvantaged households and society as a whole. Hence, it is obvious that for a developing country like Albania, a progressive tax structure is highly desirable to offset inequalities in income distribution.

Another way to improve personal income tax system in Albania may be to consider using family based taxation similar to the United States standards of family based personal income tax

system (Stiglitz, 2000). The current personal income tax system in Albania requires individuals, instead of families as a whole, to file their own tax return which does not take into account how the taxpayer's ability to pay is affected by the family situation. It is obvious that the family based taxation should be preferred in order to avoid any discrimination of the overall tax burden of families with different individual income compositions. Also, programs similar to those of the United States, such as earned income tax credits and tax credits for child care expenses, could be considered in Albania if this approach is adopted.

Considering the current worldwide economic crisis, an increase in personal income threshold would be preferred in order to stimulate domestic demand in Albania. The current threshold is 10000 ALL, which is approximately 1/3 the average monthly income that according to Albanian Investment Development Agency is around 36000 ALL. The increase of the threshold appears necessary and definitely will benefit the country's low income group. However, the threshold should be linked to inflation and the price index in order to avoid unserious increases. In the long run, it is expected that the tax revenue from personal income tax will continue to increase as Albania's formal sector continues to grow. The current level of personal income tax in total taxes (less than 10%) is far below the level of most industrialized countries like U.S where individual income tax collections make up more than 50% of total taxes (IRS,2011). Current policy debates on Albania's income tax focus on the initiatives to implement more inclusive social programs and to expand the tax base by including other sources of income such as income from individuals who work in farming and fishing.

To conclude, the goal of personal income tax policy is to address issues of economic disparities and attain social equality. Future fiscal reforms should focus on income tax policies that encourage fairness and impartiality and promote compliance. Vertical equality can be achieved by creating higher thresholds and higher progressivity, and horizontal equity can be achieved by allowing reasonable exemptions for low-income and disadvantaged groups. To add to these policies, more inclusive social programs need to be implemented as well such as providing new tax liabilities accompanied by new benefits to the self employed. Likewise, the reform of these policies should expand the tax base to generate sufficient revenue and cover a more rural population.

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