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The Pay-As-You-Earn Tax on Wages

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Although undeniably useful in immediately strengthening collections,withholding does not obviate the need to strengthen the tax administration itself.

—Richard M. Bird and Milka Casanegra de Jantscher

I. Introduction

Although all withholding taxes aim to tax income when it is earned, only withholding on wages is commonly known as pay-as-you-earn (PAYE).¹ This tax plays an important role in nearly all national tax systems.²

The PAYE is an important and easy-to-collect revenue item. Its claim on the resources of the tax administration is limited, particularly if return filing by employees is restricted to those who earn substantial other income or are entitled to significant special deductions, or both. A simple PAYE does not complicate the employer's wage administration. Compliance control can focus on employers only, rather than on individual employees. Nonconsolidation with other income is more acceptable when other income is also subject to withholding taxation.

A. Revenue Importance of the PAYE

The PAYE is a high-yielding revenue collector in many countries. It generates a lion's share of the personal income tax and, in industrial countries, usually exceeds the revenue of the general sales tax or value-added tax (VAT) by an ample margin. This is illustrated in Table 1 by the list of countries with mature personal income and VAT systems in tax year 1991.

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¹The basic mechanics of PAYE withholding are outlined in ch. 14, sec. XII, *supra*.

²Notable exceptions are France, Switzerland (for resident employees), and Singapore.

Table 1. Wage Withholding Tax

Country	(As a percentage of personal income tax)	(As a percentage of VAT)
Belgium	76	146
Germany (West)	72	119
Luxembourg	70	104
Netherlands	86	144
United Kingdom	76	117
United States	88 1/	...

Sources: Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries, 1965–1992 (1993); U.S. Internal Revenue Service.

1/ For the United States only, the number includes other withheld income tax and income tax to be refunded. The net number should be in excess of 80. The United States does not have a VAT.

In developing countries, personal income tax collected from wages represents an even higher percentage of total personal income tax revenue. However, depending on the actual rate structure, the VAT often generates more revenue in these countries than the PAYE. This is particularly true in countries in transition. In Russia, for instance, the wage withholding is nearly 100 percent of total personal income tax, but VAT revenue amounts to about three times the PAYE revenue.

B. Limited Use of Administrative Resources

More so than in industrial countries, developing and transition countries need to use their skilled administrative resources selectively. A relatively simple PAYE would allow the tax administration to collect a large share of the personal income tax with only a minor use of its resources. As such, the administration should aim at a final tax collection through the PAYE. Return filing should take place only when substantial other income or significant deductions occur and, therefore, when major adjustments to the withheld tax would need to be made. Collection of every "dollar" of taxes due can never be realized, and efforts to do so will not be cost-effective.

Because of the PAYE, more administrative resources can be deployed in those areas where tax revenue is more at risk than in wage withholding. In the area of personal income taxation, compliance control can focus more on auditing, and collecting from self-employed persons; corporate income and sales tax payers can be better monitored.

The tax administration should focus its limited resources for PAYE purposes on the compliance control of the withholding agents, the employers. Instead of checking a large number of individual employees, the administration can focus on a limited number of employers. The employers must file monthly and pay the withheld tax on a monthly or more frequent basis. The administration should monitor the filing and payment records of the employers closely and follow up immediately whenever it is observed that one has stopped filing or paying. In addition to this kind of processing control, selective audits must be undertaken to ensure that tax is withheld from all wages paid and that the tax is properly computed.

C. Reduction in Return Filing

A PAYE substantially reduces the necessity of requiring employees to file returns. Employees with only wage income and standard deductions can be taxed on a final basis through withholding. Exemptions for minor amounts of other income and minimum requirements for special deductions can reduce return filing even further. However, practices differ substantially among countries.

In countries such as Australia, Canada, Sweden, and the United States, all wage earners whose income exceeds the exempt amount are still required to file an income tax return.³ Tax withheld is credited against the total income tax due, and the difference is paid or refunded. Countries like Chile, Germany, Hungary, the Netherlands, and the United Kingdom, however, use the PAYE as a final income tax for most wage earners.⁴ Administrative and compliance costs are lower under final withholding because many taxpayers are not required to file returns. These countries regularly implement additional measures to expand the finality of the tax. The withholding schemes are often modified to make them more compatible with the general income tax, and sometimes a limited filing threshold is applied to those with other income.

A different situation exists when a person's tax liability is based not on total income, but rather on separate tax schedules for each category of income.⁵ In this situation, no special adjustment is needed for PAYE to be a final tax.

D. Other Withholding Taxes

Although this chapter deals only with the PAYE, it should be mentioned that withholding taxes on other income would allow further reduction of return filing. The fact that such other income is not consolidated with wage income is not necessarily a serious problem if (1) the wage income is modest, (2) the amount of other income is not too large, and (3) a withholding tax has been collected from other income.

Withholding taxes on dividends and interest are fairly common in national tax systems. Several countries have introduced withholding taxes on an even broader basis.⁶

³See USA IRC § 6012; CAN ITA § 150; AUS ITAA § 161; Graeme Cooper, Robert Deutsch, and Richard Krever, *Income Taxation* 23–24 (1993); Harvard Law School, International Program in Taxation, *Taxation in Sweden* 579 (1959); Peter Melz, *Taxation of Individuals in Sweden*, in *Taxation of Individuals in Europe* (IBFD 1997).

⁴See *infra* sec. III(B).

⁵See *supra* ch. 14, sec. II(A).

⁶See *id.* sec. VIII(D).

II. PAYE Calculation Methods

There are three basic systems for calculating the amount of PAYE tax to be withheld: simple PAYE, cumulative PAYE, and year-end adjusted PAYE.

The simple PAYE system applies the monthly withholding table on wages for that month, with no adjustments for wage changes in the tax year. Any difference between the tax withheld and the total income tax liability is accepted as the price of a simple tax system or is resolved by the filing of a return. The following example illustrates the simple PAYE mechanism.

An employee with a monthly taxable wage of \$1,000 has an annual income of \$12,000 and is subject to the following income tax rate scale:

Annual Income (In U.S. dollars)	Tax on Bracket of Income (In percent)
0–2,400	0
2,400–6,000	20
6,000–15,000	30
15,000 and higher	40

The tax period is the calendar year. The employee's income tax liability for the year is \$2,520 (\$2,400 at 0 percent, \$3,600 at 20 percent = \$720, and \$6,000 at 30 percent = \$1,800). Dividing the income tax liability into 12 equal monthly portions results in a monthly withholding tax of \$210.

The calculation can be done each month. The monthly taxable wage is multiplied by 12, the annual income tax liability is computed, and that liability is divided by 12 for the monthly withholding. If, in the above example, the monthly taxable wage increased to \$1,500 on July 1, the estimated annual income would be \$18,000, the income tax liability \$4,620, and the monthly withholding for the second half of the year \$385.

Basically, multiplication and division by 12 represent nothing more than the steps for deriving a monthly withholding table from the annual income tax rate brackets. Therefore, most tax administrations have published monthly (and weekly) withholding tables as a service to employers—the withholding agents. In the above example, the monthly withholding table (dividing annual income by 12) would be:

Monthly Wage in (In U.S. dollars)	Tax on Wage Bracket (In percent)
0–200	0
200–500	20
500–1,250	30
1,250 and higher	40

The withholding table can be, and often is, more elaborate. Many administrations publish tables for tax at small wage intervals of, say, \$10. Standard deductions are often incorporated. For example, with a standard deduction of 5 percent of wage income, the tax withheld from a gross wage of \$200 is computed on a wage of \$190.

The monthly withholding tables assume that annual income is 12 times the monthly income (weekly income multiplied by 52). Monthly wages, however, may vary. If, in the above example, a monthly wage of \$1,000 increases to \$1,500 on July 1, the monthly withholding in the second half of the calendar year is based on an annual income of \$18,000 rather than on the actual income of \$15,000 (6 times \$1,000 plus 6 times \$1,500). The PAYE on the \$9,000 earned in the second half of the year, therefore, is computed on the assumption that \$1,500 is taxable at the marginal rate of 40 rather than 30. The result is that the total amount of PAYE tax withheld exceeds the taxpayer's yearly income tax liability by \$150.

Some countries—for example, the United Kingdom and Russia—continuously recompute the PAYE to make the tax withheld as close as possible to the actual income tax. This system is called the *cumulative PAYE*.⁷ After a wage change, the PAYE of the next pay period is increased by the month's share of the difference between the income tax on total income prospectively to be earned during the tax year, and the tax already withheld in the tax year. Consequently, in the above example, the July 1 wage increase from \$1,000 to \$1,500 a month will increase the monthly withholding tax from \$210 to \$385. The tax liability on an annual income of \$15,000 is \$3,420 (6 months at \$1,000 and 6 months at \$1,500), of which \$1,260 has already been collected (six months at \$210 a month). Still to be collected is \$2,160 (\$3,420 - \$1,260). The monthly withholding for the remaining six months should therefore be one-sixth of this amount, or \$360.

Several countries, notably Germany and Japan, apply a PAYE that is a hybrid of the simple PAYE and the cumulative PAYE.⁸ During the tax year, this PAYE is similar to the simple PAYE; monthly withholding is based on the tables without regard to tax withheld in previous pay periods. At year-end, however, the final withholding is computed on a cumulative basis. The total wages paid and total tax withheld during the year are compared with the tax liability based on the actual wages paid, and a year-end adjustment is made.⁹ The year-end wage payment can therefore differ markedly from the payments made during the year. This system is called *year-end adjusted PAYE*.

In a simple PAYE, payment of substantial nonperiodic wage income by the employer (for example thirteenth month and annual leave allowances) may cause a problem.¹⁰ Tax withheld from nonperiodic payments will be higher when the income is added to and taxed as ordinary wage income of the pay period than when averaged out over the tax year. A standard solution is to tax the nonperiodic payments at a proportional rate rather than at the progressive rate in the

⁷See Appendix A for discussion of United Kingdom and Russia. In the United States, an employee can request, and the employer can agree to apply, the cumulative system. See USA IRC § 3402(h)(3).

⁸See DEU EStG §§ 38 – 42b; National Tax Administration, *An Outline of Japanese Tax Administration* 26 – 28 (1993).

⁹For a monthly wage that increases from \$1,000 to \$1,500 in July, the total tax withheld is 6 times \$210 plus 6 times \$385, or \$3,570. The income tax liability is \$3,420. Therefore, the PAYE in December is reduced by \$150 from \$385 to \$235.

¹⁰A similar problem may occur in the year-end adjusted PAYE when such wage income is paid before year-end.

pay period. That proportional rate is based on the annual ordinary wage income of the employee and the additional tax due because of the additional nonperiodic payments.

III. Finality of PAYE

A. Preliminary PAYE

As mentioned earlier, countries like Australia, Canada, Sweden,¹¹ and the United States continue to require that all taxpayers with taxable income file a return, including wage earners with only one job who are not claiming a significant amount of special deductions. Why have these countries kept this filing requirement?

An argument in favor of return filing may be that the prospect of claiming tax relief (deductions or tax credits), however small they might be, gives taxpayers a satisfaction that can outweigh the burden of filing. Another argument is the awareness of paying taxes that comes with the filing of a return. As a taxpayer and a member of society, the person filing the return will be more aware of his or her tax burden and, therefore, better prepared to exercise his or her constitutional rights. A third argument is the prospect of a refund—because of deductions or imprecision in the withholding—that is inviting to the taxpayer. A May 1992 report of the U.S. General Accounting Office, "Opportunities to Reduce Taxpayer Burden Through Return-Free Filing," states that final withholding would reduce refunds and, consequently, is not likely to be accepted by taxpayers because: "many taxpayers look forward to receiving refunds and look upon the refund as a form of forced savings."¹²

A fourth argument may be the existence of income tax credits for lower-income taxpayers.¹³ Given these credits as vehicles for income support, return filing generates the information needed for means testing. Examples are child support credits and credits to compensate for an assumed disproportionate burden of sales taxes.

The four countries mentioned above are actively exploring ways to reduce the compliance burden on taxpayers while retaining return filing. Because their tax administrations are largely computerized and their compliance control is based on information obtained from third parties (employers, companies, and financial institutions), these countries are considering systems where the initiative for the return lies with the tax administration. The tax administration would initially complete the return, based on the information available, and would then mail that

¹¹In the case of Sweden, return filing has been facilitated by the rule that tax returns are prepared by the tax office, based on information returns received. The taxpayer has to supplement the return as needed, but if the return is correct, he or she just signs it. In Denmark, the taxpayer need not even sign if there is no change to make.— L.M.

¹²U.S. General Accounting Office, *Opportunities to Reduce Taxpayer Burden Through Return-Free Filing* (1992). Until 1992, the U.S. withholding system was designed to withhold more than was indicated on the annual income tax tables and, therefore, led to a large volume of refunds.

¹³*E.g.*, USA IRC § 32 (earned income tax credit).

return to the taxpayer for confirmation.¹⁴ Such a system would require a considerable administrative effort. The tax administration would have to be fully computerized, as would its suppliers of information. A major concern, however, is whether taxpayers will promptly correct errors if the tax administration has prepared a return that underreports income.

Other issues that affect countries' choice of a return filing system are, first, the degree to which the existing income tax is schedular or global. In a fully schedular income tax system, a final PAYE will cause few problems, probably limited to situations where the taxpayer has a second job. In a global system, usually the progressivity of the tax rate and the tax exemption for a minimum income (personal allowance) make some return filing necessary. This also happens when a taxpayer can claim special deductions that cannot easily be included in the wage withholding.¹⁵

Second are the income tax rates. If they are steeply progressive, the accumulation of income from different sources may substantially increase the total tax liability. To determine this liability, a return is needed. If a taxpayer receives income from only one source, final withholding is still possible. The situation is rather different with a flat income tax rate. Final withholding is an option even in the context of a fully comprehensive income tax, provided that personal allowances are deducted only under the withholding scheme for full-time employment.

Third is whether the taxable base of the income tax is individual income or the joint income of a married couple.¹⁶ When employment income is taxed individually, it is often possible to tax that income through a final withholding tax at source. Final taxation at source of the combined employment income of a married couple, however, is almost impossible. Whenever such income needs to be aggregated for income tax purposes, a joint return must be filed. This is an important reason why return filing in the United States is mandatory for all taxpayers.

Fourth is the distribution of nonwage income. In a society where a large portion of the population regularly receives investment income, the filing requirement seems appropriate. Where most of the population receives only wage income, however, final withholding is often appropriate.

B. Semifinal PAYE

A semifinal PAYE, through which at least some employees are taxed only through withholding and do not have to file a return, is the most common approach to wage taxation. Countries using this method apply different PAYE systems. For example, the Netherlands uses

¹⁴See *supra* note 11.

¹⁵Many countries, even those that require all taxpayers to file returns, allow special deductions to be claimed through the withholding system. Examples are deductions for (extraordinary) medical costs, mortgage interest, and certain life insurance contributions. See *supra* ch. 14, sec. XII(A).

¹⁶See generally *supra* ch. 14, sec. IX(B).

the simple PAYE system, Germany the year-end adjustment system, and the United Kingdom the cumulative system.¹⁷ Basically, the choice of system depends on the trade-off between the burden for taxpayers of filing returns and for employers of withholding.

The introduction of so-called filing thresholds can reduce the number of returns that must be filed. Only if other income surpasses a minimum amount does a return declaring all taxable income need to be filed. Below that amount, other income is not consolidated with the primary income from regular employment, and the tax on total income is that collected at source. For secondary employment income, that tax is the PAYE withheld by the second employer. Insufficient withholding at source results in a tax advantage for the taxpayer, which is not recaptured because of the filing threshold. Beyond the threshold, all taxable income is consolidated on the return and insufficient withholding offset by an increased income tax liability on assessment.

A filing threshold can also be applied to income tax deductions not included in the withholding scheme. Employees should not be allowed to file a return to obtain an insignificant refund. In considering comparable filing thresholds for other income (resulting in additional tax payable) and for deductions (resulting in a refund), it seems prudent to allow a higher threshold for the former than for the latter.

Filing thresholds can be used to keep the number of returns in line with the capacity of the tax administration. By initially setting the thresholds fairly high, a developing country can apply a de facto schedular system to most employees. Only employees with substantial other income, including a well-paying second job, or significant other deductions would file a return. With increasing administrative resources, a country can bridge the gap between the schedular system and the comprehensive system by gradually reducing the thresholds.

Filing thresholds are being used, for example, in Chile and the Netherlands.¹⁸ Chile further reduces return filing by disallowing filing for refund purposes.¹⁹ Tax withheld from wages is final, even when an individual was employed for only part of the tax year.²⁰ The filing of a return, with consolidation of total income, is required, however, when other income is received in excess of the filing threshold.

Other employment income can be taxed at source like the wages from the main source of employment. The same withholding tables are applicable. The person earning wages from two jobs, however, benefits from a second set of personal allowances and reduced progressive rates that is not available to the person who earns the combined wage income from one job. It may be

¹⁷See app. A(1)(a) *infra* (Netherlands); app. A(1)(b) *infra* (United Kingdom); sec. II *supra* (Germany).

¹⁸See CHL IR § 65(3); NLD

¹⁹CHL IR § 65(3) is applied to this effect.

²⁰The Chilean PAYE system is categorized as a semifinal system because of its "one-way" finality. PAYE withheld cannot be reduced (refunded), but it can be increased by additional income tax because of other income.

desirable not to allow the employee to claim more than one set of personal allowances. For instance, in the United Kingdom, where the tax administration has to validate the personal allowance claim, only one claim form is validated.

C. Final PAYE

Theoretically, a final PAYE has a monthly withholding table that is not as such derived from an annual income tax rate. In practice, however, the annual withholding table (i.e., the monthly table, of which the income brackets are multiplied by 12) is similar to the income tax rate applicable to, for example, self-employed persons. The main characteristic of the final PAYE, however, is that income is taxed at source rather than in total.

Because the withholding table is not formally linked to the annual income tax levied on other taxable income, the tax period for withholding can be defined for that purpose only. The ability to pay tax can be based on annual income, as in the case of entrepreneurial income, but it can also be based on monthly income.²¹

If the relevant tax period of the final PAYE is a month, wage fluctuations do not pose a problem because each month's wage is taxed independently. It is taxed independently not only of other income, but also of wages received in previous months or that will be carried in following months. In many developing and transition countries, this simple version of the final PAYE is used.²² In Russia, however, the law stipulates that the final (monthly) PAYE should be levied cumulatively within the calendar year. The tax period for the PAYE is the calendar year and, in principle, the employers apply the cumulative version of the final PAYE.

Many of the comprehensive income tax problems caused by other income are not found in the final PAYE. However, a major problem arises from wage income from a second job. In the comprehensive income tax, the filing of a return is the instrument used to address that problem. In the final PAYE, that instrument is not available. Either the problem should be resolved by the primary employer integrating all withholding (as discussed below, a complex alternative, but one that is stipulated in most countries of the Commonwealth of Independent States (CIS)), or income from each job should be taxed separately. In the latter case, the employee receives the personal allowances twice and escapes the full impact of progressivity unless a special mode of taxation is designed for secondary types of employment.

IV. Administrative Burden

²¹The tax period is basically an accounting convention. Although a calendar year is generally used, many countries allow averaging of annual income over an extended period and most countries provide for a carryover (carryforward and also often carryback) of losses into other years. See Richard B. Goode, *Long-Term Averaging of Income for Tax Purposes* in *The Economics of Taxation* (Henry J. Aaron & Michael J. Boskin eds., 1980).

²²In Chile, the comprehensive income tax requires that a return be filed when substantial other income is involved; however, a return for a refund of PAYE—because of short-term employment, for instance—cannot be filed.

With respect to the taxation of wage income, three parties are involved—the employee, the employer, and the tax administration. Their involvement varies from country to country, but the emphasis is on the employer and the tax administration.

Being the withholding agent by law, the employer is involved in collecting income tax from wages. To both the employee and the tax administration, the employer is rendering a tax service. Regarding the employee, it can be argued that the costs of providing these services are part of the costs of hiring labor. A reimbursement for these services by the beneficiary, the employee, is therefore not to be expected.

A different view could be taken with regard to the administrative services provided to the tax administration. The general practice of countries is to consider the obligation to withhold as part of general tax compliance obligations, the cost of which is not reimbursed by government. However, withholding may be better viewed as fulfilling part of the tax administration's tax collection function. The tax collection function is one of public authority, not undertaken in the interest of those who deal with the administration. Therefore, the tax administration should not charge a fee for its collection function and, where that function is partially delegated to the private sector, the private sector should be reimbursed for costs incurred. Yet, employers rarely receive such reimbursement.²³

Although explicit reimbursement of collection costs occurs only in exceptional cases, employers benefit from the lag between the time taxes are withheld and when they are transferred to the government. Without the withholding requirement, the employees would receive their wages in full at the end of the pay period. Because of the withholding, the employers retain use of part of the wage bill until it is transferred to the government. Assuming monthly wages, and payment of the withheld tax at the end of the following month, the employer's benefit is equal to the interest on a perpetual loan in the amount of the tax bill for one month.²⁴ In particular under conditions of high inflation, the time lag between withholding and transfer by the employer should be kept relatively short to safeguard the real value of the PAYE revenue.²⁵

Given the expectation that employers will keep a basic accounting of their revenue and expenditure and, therefore, also of wages paid, a simple PAYE should not be a great burden to the employer. The tax to be withheld can be read from the withholding tables and deducted from gross wages.²⁶

²³In Switzerland, which applies the PAYE to nonresident employees only, the cantons allow employers to retain a small percentage of the tax withheld from employees as compensation for their collection service. See Cedric Sandford, *General Report: Administrative and Compliance Costs of Taxation*, 54b Cahiers de Droit Fiscal International 36 (1989).

²⁴For large employers, a shorter transfer period may be applicable.

²⁵See Vito Tanzi, *Inflation, Lags in Collection, and the Real Value of Tax Revenue*, in *Public Finance in Developing Countries* (1991).

²⁶The appropriate bookings in the accounts are (wage \$1,000, tax \$210):

Withholding		Payment to Treasury	
<i>(In units of domestic currency)</i>			
Debit account "Wages"	\$1,000	Debit account "Wage tax"	\$210
Credit account "Cash"	\$790	Credit account "Bank"	\$210
Credit account "Wage tax"	\$210		

The year-end adjustment system and particularly the cumulative system require much more work from the employer. It goes beyond withholding as such and borders on an assessment function.

The final PAYE systems applied in the CIS countries typically require the primary employers to include wages and tax withheld from secondary jobs.²⁷ Employers in Russia must also administer a cumulative PAYE. This workload is excessive for the employers.

As mentioned above, in all withholding systems, special allowances and deductions can be incorporated on an individual basis. Withholding adjustments should be based on authorization from the tax administration. This can result in substantial work for the employer, particularly if there are many special deductions and they change during the tax year; however, the inclusion of a few widely used deductions at fixed amounts for the tax year should not be too great a burden to the employer.

The decision on what type of PAYE scheme to adopt in a particular country should ideally be informed by data on the costs to the government and the private sector of collecting the personal income tax under alternative systems. A withholding tax implies a transfer of collection costs from the administration to the withholding agents, and more so with elaborate withholding schemes. Comparing the costs of the withholding schemes would help evaluate their efficiency. Unfortunately, little comparative data is available.

V. Social Security Contributions

Employers are also the payers of and withholding agents for social security contributions.²⁸ In many countries and for many employees, these contributions may be larger than the PAYE.

Withholding and paying of the PAYE and social security contributions are not usually integrated. Often, the base for both levies is different, the accounting is separate, and the payments are made to different agencies. Integration of the two withholding systems is an urgent matter, with good prospects for administrative savings.

²⁷RUS IT arts. 8-11.

²⁸See vol. 1, at 392-94.

A first step toward integrating the two withholding systems is to combine the payment and control systems of the PAYE and social security contributions.²⁹ If employers indicate the amounts of PAYE and social security contributions, they can then transfer the total amount withheld to one government account, which the authorities can distribute between budget and social security funds. In addition, government control of the withholding could be delegated to the audit functions of the tax administration only. The audit of the PAYE would be extended to social security contributions as well, so that the social security administration would not run its own audit program, which would largely overlap with PAYE audits.

Further integration of the two systems requires the harmonization of the base on which PAYE and social security contributions are levied. Currently, because social security contributions are often deducted from the PAYE base, employers must compute PAYE and social security withholding separately. With a harmonized base, total withholding can easily be calculated.

The scope of the integration of income taxation and social security contributions could be extended to self-employed persons. For the generally applicable contributions (i.e., payable by all individuals), the income tax rate could then be combined with these contributions into one income levy. The shares of income tax and social security contributions, with a distribution to the budget and the social security authorities, could be preserved by enacting annually the two relative percentages separately.

The Netherlands recently integrated the collection of income tax and generally applicable social security contributions. A simple rate structure is used, with one base for both income taxation and social security levies. The resulting income levy contains a social security component to finance social security funds and an income tax component.

The social security component is payable only up to a certain income level. Beyond that level, only income tax is collected. For both the income tax and social security purposes, the same threshold applies. The most difficult integration issue was the transfer of the employer's share of social security contributions to employees with a compensating increase in wages. That transfer was necessary to establish one base for the new combined levy and equal circumstances between employed and self-employed persons. A one-time transfer with compensation on a certain date was rejected because it might have increased the social security burden on employees in the future. A compromise was reached, involving transfer and compensation over a transition period, the amount of the transfer and compensation being based on the current contributions rate for the year in question.

VI. Administrative Constraints of Developing and Transition Countries

In industrial countries, the administrative capability of the tax administration, employers, and employees allows for flexibility in shifting the administrative burden from one participant in

²⁹In Canada, Sweden, and the United States, for example, the tax administration is also responsible for collecting social security contributions from employers.

the collection process to another. Electronic data processing permits heavy involvement of both tax administration and employers. A comprehensive taxpayer education and taxpayer compliance program allows substantial employee participation. For these countries, administrative constraints are usually not a major issue in the design and operation of the collection system.

Although the workload of the tax administration, employers, and employees may vary among countries, the focus of every PAYE is on employers as the withholding agents. They initially compute, collect, and account for the income tax on wages and deposit the tax into the treasury accounts. It is their performance of these duties that determines the quality of the PAYE system. The tax administration monitors the filing and payment compliance of employers and ensures that they have complied with the law in computing and transferring the withheld tax by carrying out audits where necessary.

In developing and transition countries, a limited number of large employers may have the administrative capability, experience, and personnel to administer a relatively complex PAYE. It is prudent, however, to assume that on average most can manage only a fairly simple PAYE. Also from the point of view of control by the tax administration, the PAYE should be accessible to simple audit techniques and should not require highly skilled audit input.

Regarding the PAYE in the context of a comprehensive income tax, tax administrations of developing and transition countries do not have the means to process and assess large numbers of employee returns. Therefore, the emphasis in these countries should be on a PAYE that is as final as possible. With the PAYE collected, the income tax liability of the majority of the taxpaying employees should be met and no further collection required. Only a relatively small number of employees should be required to file an income tax return, either because these employees are in the highest income brackets or because they receive substantial amounts of other income. The thresholds above which returns must be filed should be based on the tax administration's ability to process returns. Whether or not all of the employees' other income is accounted for in the overall income tax is an issue on which compromise is necessary if the income tax collection system is to be manageable and reasonably equitable. It is better to enforce a reasonably equitable system properly than a perfectly equitable system poorly.

In the countries where the PAYE does not function in the context of a comprehensive income tax, but is the final income tax on wages, employees file returns only if they have other income. The need to limit the number of returns filed is equally important for the schedular income tax as for a comprehensive income tax; therefore, equally high thresholds should be set for filing. Where income is derived from a second job, a return cannot be filed to combine the wages. However, the alternative of integrating the two withholding schemes by requiring the main employer to include the second job wages and the PAYE in the withholding would overly complicate the PAYE system. The only possible adjustment is to disallow the claim of personal allowances from the second job.

The fact that no returns are filed with the administration implies that tax administrations cannot verify against the return tax actually withheld and paid by employers.³⁰ Final taxation of employees through a PAYE system, therefore, requires regular auditing of the employers' withholding records. These audits should check withholding procedures and transfer of the withheld tax, but should also serve as a check on employees' claims on personal allowances and other deductions.

VII. Impact of Inflation on Withholding

Many countries in Latin America and the CIS countries suffer, or have suffered, from high inflation. In some Latin American countries, the PAYE rate brackets and the personal allowances are adjusted monthly to reflect price increases; in the CIS countries, such adjustments are generally made less frequently, but do occur within the tax year.³¹

In a final PAYE, as is applicable in many CIS countries, the tax period is essentially a month instead of a year. What happened in the preceding months and will happen in future months is not relevant for wage taxation in the current month. A recomputation of wages and tax of an earlier withholding period into values of the monetary unit at year-end is therefore unnecessary.

In Latin American countries, the PAYE functions as a withholding instrument of a comprehensive tax on a calendar year's income. With full inflation accounting, the tax liability should be computed in year-end values of tax rate and personal allowances, although current values have been used in the monthly withholding. For a simple illustration of this, it is assumed here that wages and personal allowances increase monthly by 10 percent because of inflation. Given a wage of \$100 at the end of January, and personal allowances (the monthly share of it) of \$20, the numbers at the end of each quarter are as follows:

	March	June (In units of domestic currency)	Sept.	Dec.
Wages	121	161	215	285
Personal allowances	24	32	43	57

For income tax purposes, the personal allowances for the year are 12 times \$57, or \$684. Taxable wages at year-end values are 12 times \$285, or \$3,420. However, wages may also have changed in real terms, so total wages for the year in year-end values cannot simply be computed

³⁰In most countries, employers must file a PAYE return together with the payment. The return should contain information on the total wage bill and the tax withheld. Annually, the employer should supply wage and tax information for each employee. That information, however, is not sufficient for audit purposes.

³¹These adjustments prevent real increases in tax revenue solely because of inflation. Real decreases in revenue resulting from collection lags may occur because of late transfer of the withheld tax by the employer. See Tanzi, *supra* note 25; See also *supra* vol. 1, ch. 13.

by multiplying the year-end wage by 12. It is necessary to recompute each monthly wage and withheld tax at the year-end value.

In the example above, the recomputation of each monthly wage in year-end values does not reduce or add to the tax already paid. Provided that the tax brackets are properly adjusted for inflation, the tax already withheld matches the year-end liability when revalued in year-end prices. In many cases, in fact, a recomputation is not necessary, as it would result in only minor changes that would not justify the complex cumulative system. In Chile, for instance, the system of inflation accounting has been greatly simplified.

Additional difficulties arise when other income, including other wage income, is involved and a return must be filed to declare the cumulative income. Wage income is generally evenly spread over the tax year, while this may not be true of other income. This raises the question of how to compute that income in year-end values. The administrative burdens involved for both the taxpayer and the tax administration necessarily lead to a limitation of return filing. Only in cases where substantial other income is received should returns be filed.

VIII. Withholding Systems: Country Examples

The PAYE systems of nine countries—three industrial, four developing, and two in transition—are described in Appendix A. The industrial countries are the Netherlands, the United Kingdom, and the United States; the developing countries are Chile, Indonesia, Kenya, and the Philippines; the countries in transition are Hungary and Russia.

As Appendix A shows, a fairly large number of different PAYE models have been implemented in national tax systems. A clear pattern of models used by industrial countries on the one hand and developing and transition countries on the other hand cannot be distinguished. Nor is there any evidence that developing and transition countries are using simpler models than industrial countries. Cumulative systems are used by all groups, as are year-end adjustment systems. A reduction of the number of returns filed is an objective in most countries.

Although the authorities may have designed (and legislated) a sophisticated tax system, lack of administrative expertise and resources may render it quite basic. In a number of countries where employees are required to file income tax returns, the tax administration does not do much with them. In Russia, employers are supposed to administer a cumulative assessment procedure of overall employment income; however, the practice of withholding by a Russian employer may be not much more than a flat-rate payroll tax on wages paid by that employer.

In the following two tables, the main characteristics of the PAYE systems of the nine countries are summarized.

Table 1. Characteristics of PAYE Systems in Nine Countries

Country	Type of PAYE System			Finality of PAYE			Involvement of Tax Administration		
	Simple	Cumulative	Year-end-adjusted	Preliminary	Semi-final	Final	Personal Allowances	Other Deductions	
Chile	X				X 1/2				
Hungary			X		X				
Indonesia			X		X				
Kenya	X				X			X	
Netherlands	X				X 1/2			X	
Philippines				X		X			
Russia		X				X			
United Kingdom		X			X		X		
United States	X			X					

Sources: Appendix and references at the end of this paper.

1/ Filing thresholds are applicable.

2/ PAYE is not refundable.

3/ If income exceeds a certain level, a return must be filed.

Table 2. Additional Characteristics of PAYE Systems in Nine Countries

Country	Included in the PAYE Are						Integrated with Social Security Contributions
	Personal allowances	Other deductions	Other wage income	Other nonwage income	Personal Allowances Disallowed for Second Job		
Chile	X						
Hungary	X	X					
Indonesia	X						
Kenya	X	X	1	1			X
Netherlands	X	X	1	1			
Philippines	X				X		
Russia	X	X	X				
United Kingdom	X	X	X	X ²			3
United States	X	X	1	1	X		3

Sources: See appendix and laws cited therein.

^{1/} Other income may limit other deductions.

^{2/} Included to some extent.

^{3/} Payment and audit programs are integrated.

IX. The PAYE Recommended for Developing and Transition Countries

Tax legislation should be compatible with the standards used by the tax administration, withholding agents, and taxpayers, in the sense that the compliance required is at par with available and enforceable compliance. Tax legislation requiring high voluntary compliance and administrative control, but executed by a weak tax administration and inexperienced withholding agents and collected from uncooperative taxpayers will not yield the budgeted revenue, nor realize the intended distribution of the tax burden, or achieve the intended distribution of the tax benefits.

Such legislation will hamper economic development and further reduce the population's willingness to comply with government policies.

Given developing and transition countries' administrative constraints, a simple PAYE should be given preference over any other PAYE system, regardless of whether the PAYE functions in the context of a comprehensive or a schedular income tax system.

A. Simple PAYE

It is very important that the PAYE be simple. The tax administration, not the employer, should perform the assessment function. A simple PAYE therefore, implies that an employer is not required to

- administer other income of the employee, whether that other income is wages from a second job or nonwage income. The PAYE covers only wages earned from the employer administering the withholding. That coverage is complete, however, including earnings in cash and in kind. For wages in kind, the employer is provided with clear and explicit valuation guidelines by the tax administration,³²

- assess or withhold tax from accumulated taxable wages earned in periods that extend beyond the regular pay periods of a week or a month. Personal allowance and wage changes from one pay period to another do not affect the withholding for a given pay period. The employer is not obliged to add pay periods together and adjust the tax withheld for those periods into a tax assessed for the whole year. Cumulative and year-end adjusted PAYE systems are not simple.

- compute the tax to be withheld from wages paid. The employer is able to work with withholding tables that are designed, produced, and provided free of charge by the tax administration. The tables are easy to use so that the employer can read the PAYE straightforwardly from them. Following a column of taxable wages, columns of tax to be withheld for each personal allowance group (e.g., single, married, one or more dependent children) list the applicable tax amount. The wage column has small wage steps, and variations of wages between steps do not affect the amount of PAYE.

³²See *supra* ch. 14, sec. XII(D).

A simple PAYE system permits final income taxation of an employee who holds only one job, is entitled to personal allowances, and may claim only widely used other deductions for income tax purposes. Such an employee does not have to file a return. Therefore, the employer is required to

- collect from the employee information on the personal allowances to which he or she is entitled. Although the tax administration provides the forms to be completed by the employee and randomly checks the information during employer audits, the forms are filed with and kept by the employer.

- compute wages for withholding purposes, deducting a proportional share of personal allowances and widely used deductions. The employer includes widely used deductions to limit further return filing by employees. The simple PAYE, however, is not used for special deductions claimed by only a small number of employees; for these deductions, a return must be filed.

- maintain wage withholding records for each employee, containing entitlement to personal allowances, other deductions authorized by the tax administration, totals of taxable wages and PAYE withheld in the tax year to date, and payments to the treasury. Taxable wages include those in kind, valued on the basis of clear and explicit tax administration guidelines. If (as it generally should) the tax administration uses a taxpayer identification number (TIN), the records are identified by that number.

- deposit the tax withheld each month in the treasury, accompanied by a document listing the total number of employees, amount of taxable wages, and PAYE withheld.

- send at the end of the tax year a report to the tax administration, and an individual statement to the employee, on wages paid and PAYE withheld and paid for each employee. The annual reporting is more detailed for comprehensive than for schedular income taxes.

To increase the finality of wage withholding, the employee is required to file a return only if substantial other income is earned, and is allowed to file a return only if significant additional deductions are claimed.

In addition, to maximize the finality of the wage withholding, an employee whose wage income varied during the tax year or who received income for only part of the tax year, may not be allowed to file a return for the purpose of a refund.³³

³³This aspect of the final PAYE of the CIS countries is used in Chile. Such a rule can be criticized as unfair. In deciding whether to adopt it, policymakers need to estimate the degree of unfairness that is likely to be involved given the rate schedule, and weigh the unfairness against the administrative costs of allowing return filing in the context of the system as a whole.

B. PAYE and a Comprehensive Income Tax

In a comprehensive income tax, the PAYE is not a tax entirely by itself. Wages are consolidated with taxable income subject to tax, and the PAYE withheld is credited against the tax on total taxable income. Given the similarity between PAYE withholding rates and the income tax rate schedule, in the absence of other income and special deductions, in principle, a credit after consolidation results in a zero liability. In short, the whole income tax exercise with return filing and assessment is essentially redundant. Therefore, most countries applying the concept of a comprehensive income tax do not require return filing in that case. The PAYE is a final tax in these circumstances.

In most countries with a semifinal PAYE, individuals must file returns when they earn other income, including wages from a second job.³⁴ Some countries have introduced so-called filing thresholds, stipulating that below a certain amount of other income a return need not be filed. A second job, however, more or less automatically requires the wage earner to file a return regardless of total income earned. As mentioned above, sometimes a filing threshold is required for return filing for a refund. Returns for small refunds are not accepted.³⁵

In developing and transition countries, taxpayer compliance is at an early stage, and the tax administration's processing and enforcement capacity is not yet up to handling a large number of returns. It is therefore urgent that return filing be restricted to those cases where the consolidation of employment income with taxable income from other sources yields substantial revenue and markedly improves the equity of the system. Generally speaking, returns should therefore be filed only by employees who (1) receive a sizable amount of other income or have significant other deductions, or (2) are in the highest income brackets. Although it can be argued that high-wage employees are properly taxed in the PAYE, it is prudent to include all relatively high income earners in the income tax assessment system.³⁶

Sizable other income, significant other deductions, and highest income brackets can be defined according to the circumstances. In an emerging market economy, with a weak tax administration and a majority of the employees working at near-subsistence levels, the filing thresholds should be fairly high. In time, as the tax administration gains experience, income tax consolidation can be given a higher priority.

A second job is a frequent source of other income in developing and transition countries. The fact that such income is not consolidated with regular employment income results, *inter alia*, in the unintended benefit of a second set of personal allowances. To eliminate that benefit

³⁴In the United Kingdom, however, other income is, at least to some extent, included in the year-end adjusted and the cumulative PAYE.

³⁵An individual whose wage income varied during the tax year may not file a return for a refund of PAYE in Chile.

³⁶*E.g.*, LSO ITA § 129(b)(i).

without resorting to income tax consolidation, the use of personal allowances must be restricted to the main employment. Some industrial countries--for example, the United Kingdom--have solved that problem by issuing allowance claim forms that are identified by the TIN and can be used to obtain only one set of personal allowances. If the nonfiling employees are registered with the tax administration, other countries can also use this system. Without such a registration system, however, the administration has limited means to control the multiple use of personal allowances in the withholding stage.

C. The PAYE and a Schedular Income Tax

In terms of the preceding section, a PAYE in the context of a schedular income tax is similar to the PAYE of a comprehensive income tax if, in the latter, sizable other income, significant other deductions, and highest income brackets are defined so that no employees meet the criteria for consolidation. This situation also indicates the difference between the two systems: in the comprehensive PAYE, consolidation of employment and other income is possible but not necessary for all taxpayers, whereas in the schedular PAYE, income from different sources is not consolidated.

Although the schedules presume that accumulated employment income will be taxed by the schedular PAYE, within the employment income schedule consolidation is not possible. The PAYE is a withholding instrument that individual employers use for wages paid. It is not suitable for withholding from the aggregate of employment income received by each employee. In the CIS countries, the main employer theoretically includes in the PAYE wages and withheld tax from a second job; however, this process is unenforceable and, moreover, is very much at variance with the concept of a simple PAYE.

Because the PAYE cannot be used for consolidation purposes, a fully schedular PAYE is an inadequate instrument for distributing the overall tax burden based on the individual ability to pay tax. Therefore, a long-term objective should be a global income tax structure in which a single rate schedule applies to an individual's total annual income. Within that objective, many employees could still be taxed in a schedular fashion, provided that persons with sizable other income are required to file a consolidating return or persons with significant other deductions are allowed to request a refund.

In conclusion, taxation of income, including employment income, should be comprehensive, and the return filing rules should be pragmatic. Initially, the filing of a return could be exceptional, limited to employees in the highest income brackets; later, it should be extended to taxpayers who regularly receive significant income from more than one source.

Appendix. Description of National PAYE Systems

The following description of national PAYE systems focuses on (1) the withholding rate versus the income tax rate, (2) the inclusion of special allowances and deductions in the withholding system, (3) the treatment of income from secondary employment and other income (4) the withholding from wage increases and nonperiodic wage income (5) the withholding for social security purposes (6) the distinction the systems may make between lower and higher wage income and (7) the information the employee and the employer must furnish to one another and to the tax administration.³⁷ It is based on the situation in 1995.

Industrial Countries

This section presents the PAYE systems of the Netherlands, the United Kingdom, and the United States, which have a comprehensive income tax. In the Netherlands, about 50 percent of employees file returns; in the United Kingdom, about 10 percent; in the United States, nearly 100 percent.

The filing of returns by nearly all employees (as in the United States) allows for a rather simple PAYE. The administrative burden is shared by employees, employers, and tax administration, without a principal role for any of them. Where employers have a larger share of the burden (as in the United Kingdom), one would expect relatively lower overall administrative costs of tax collection. Because more returns are filed, the administrative costs of tax collection should be higher in the United States. In fact, however, these costs are much lower in the United States than in the United Kingdom (about 0.5 percent of income tax receipts, versus 2 percent in the United Kingdom),³⁸ probably because of the high degree of computerization of the U.S. tax administration. Assessing returns is not a time-consuming issue for that administration, and a final withholding system is therefore not a priority for the administration.³⁹

Netherlands

In the Netherlands, an employee must submit to the employer an annual statement regarding his or her personal allowances (the so-called employee's statement). An employee who wants the withholding reduced because he or she has deductible expenses (e.g., mortgage interest), requests the tax administration to authorize the employer to do so. The tax administration authorizes a reduction only where it is likely that other taxable income will not outweigh the reduction. Only through a (reduced) authorization for other deductible expenses does other income have an impact on the withholding. The personal allowances claimed in the

³⁷For a general discussion of some of these design features, *see supra* ch. 14, sec. XII.

³⁸*See* John A. Kay & Mervyn A. King, *The British Tax System* (5th ed., 1990).

³⁹The cost of complying with the obligations to complete and file a tax return is not included in the comparison.

employee's statement are not affected by other income. If no statement is submitted to the employer, personal allowances are limited to the entitlement of a single person.

Withholding tables are based on the income tax rate, with the inclusion of a standard allowance. The tables are applied in a noncumulative fashion. The relevant pay period is basically the tax period for PAYE purposes. The tax consequences of a changing wage level, for example, are not resolved at the PAYE stage. Changes in the personal circumstances of the employee are reported to the employer by a new employee's statement. The withholding is adjusted for future pay periods only.

Each job stands on its own, regardless of wages earned in another job or income received from other sources. The withholding is taken from the wages as though these wages were the employee's only taxable income. Nonperiodic wage income is taxed at a flat rate, based on the total wage earned by that employee at that job.

Although the social security funds are outside the government budget, the generally applicable social security contributions are fully merged with the income tax rate and, therefore, also with the PAYE withholding. Part of the resulting income levy is transferred to the social security funds. The remainder, being the old-style PAYE, is recorded as income tax. The tax administration is solely responsible for collection and compliance control. The social security funds are charged a fee for the administrative services rendered by the tax administration.

The Netherlands income tax law contains strict rules regarding the filing of income tax returns. If there is an excess of PAYE withheld over income tax due (because of a varying wage level, wages earned during only part of the tax year, an increase in personal allowances during the tax year, or deductions not claimed or not permitted for PAYE purposes), a return can be filed for a refund provided the refund is not insignificant.⁴⁰ When a wage earner has other income (including wages from a second job), he or she must file a return to assess the additional income tax due if the additional income exceeds the filing threshold.⁴¹ Wage earners whose income exceeds a certain level must also file a return.⁴²

Each month, the employer must transfer to the treasury the tax withheld and file a return with the administration. Each year, the employer must inform the administration and the employees about tax and social security contributions withheld and the amount of taxable wages paid. Each employee is identified by a TIN (used for tax and social security purposes). If employees need to file a return, they include that information in the return.

⁴⁰See NLD WIB § 62.

⁴¹See *id.* § 64.

⁴²See *id.*

United Kingdom⁴³

When starting to work for the first time, the employee must file an information form (a coding claim form) with the tax administration. On that form, the employee informs the administration about his or her income tax position in terms of personal allowances⁴⁴ and other income. Based on that information, the administration determines the employee's tax-free allowance.⁴⁵ In principle, this allowance is the sum of personal allowances reduced by the amount of other taxable income on which no withholding is applicable and that is rather certain to be received. Subsequently, the tax administration informs the employer and the employee about the tax-free allowance in a "notice of coding." De facto, the involvement of the administration takes the form of an advanced income assessment.

The employer deducts the PAYE from taxable wages in a cumulative way: for each pay period, the tax to be withheld is the income tax due for the tax year inclusive of the current pay period with a pro rata allocation of the tax-free allowance, reduced by the tax already withheld in the preceding pay periods of the year. If an employee changes jobs during the tax year, he or she receives from the previous employer a statement about the tax-free allowance (the coding), wages taxed, and tax withheld; based on this statement, the new employer continues the cumulative withholding for the remainder of the tax year.⁴⁶

The coding claim forms are filed with and checked by the tax administration. If the form is not filed, a notice of coding cannot be issued, and the employer must withhold tax based on a so-called emergency code. That code allows only the basic personal allowance of a single person. In this case, only the tax-free allowance attributable to the remaining pay periods of the tax year can be used, whereas a notice of coding allows the use of the full annual allowance. An employee is required to file a new coding claim form every five years or immediately after a change in the employee's personal circumstances.

For a second job, a form is filed separately with the tax administration. Because the information on other income includes wages earned in principal employment, the notice of coding issued for the second job contains no tax-free allowances. The coding could indicate that the tax is to be withheld at a rate higher than the basic rate.

⁴³For a general discussion of the United Kingdom's cumulative PAYE, *see* John Tiley, Butterworths U.K. Tax Guide 1990-91 ¶ 6: 115 (1990).

⁴⁴Other general deductions are limited in the United Kingdom, and, if allowed, take the form of a reduction at source. For example, mortgage interest is reduced by the percentage that is the basic income tax rate when receivable by a qualified lender, who can, in turn, claim a refund from the administration. GBR ICTA § 369.

⁴⁵*See* Income Tax (Employments) Regulations 1993, Regulation 7.

⁴⁶*See id.* Regulation 18.

Other nonwage income of the employee is included in the withholding by the employer to the extent that (1) it is reported in the claims form, (2) withholding is not applicable on that income, and (3) other income is equal to or smaller than the personal allowances. Therefore, other income can reduce personal allowances to zero, but cannot increase the taxable income subject to the PAYE.⁴⁷

Social security contributions are withheld separately from the PAYE on a noncumulative basis and are partly deductible for PAYE purposes. The generally applicable contributions are payable to the tax administration. Compliance control is shared by the tax administration and the social security administration. Both administrations may make field audits.

The PAYE is deposited with the treasury on a monthly basis.⁴⁸ The tax administration is informed annually by employers of the employees' taxable income and tax withheld.⁴⁹ Each employee is identified by a social security number. Sometimes, insufficiently withheld income tax is carried forward to the following tax year (through a lower coding); in other cases, the employee is sent an income tax return.

The United Kingdom has not issued strict rules regarding the filing of income tax returns by employees. Generally speaking, taxpayers are required to inform the tax administration about income that is not taxed or is insufficiently taxed at source. The tax administration then chooses between an adjusted coding for PAYE purposes and/or an "invitation" to file a return. Taxpayers who regularly receive substantial other income are required to file a return.

United States

The withholding process begins with the employee completing a form for his or her employer, stating the number of standard personal allowances he or she is entitled to and the special expenses that are deductible from income (such as mortgage interest, local taxes, extraordinary medical expenses).⁵⁰ Special deductions in excess of the income tax standard deduction are expressed as a multiple of the standard personal allowance and are added to the number of such allowances.

Based on this form, the employer deducts from the employee's wages an amount equal to the number of claimed personal allowances multiplied by the standard allowance and applies the

⁴⁷Currently, the U.K. tax administration is contemplating using "negative tax-free allowances" when other income exceeds personal allowances.

⁴⁸See Income Tax (Employments) Regulations 1993, Regulation 40.

⁴⁹*Id.* Regulation 43.

⁵⁰See USA IRC § 3402(f)(2)(A).

appropriate withholding table.⁵¹ The withholding tables are derived from the income tax rate brackets, but include the standard deduction.

The above-mentioned form is copied to the tax administration only if an employee claims a relatively high number of personal allowances. If the employee does not submit a form to the employer, withholding is based on only one personal allowance and no special deductions. The employee must submit a new form when a change in personal circumstances results in a reduction of the number of personal allowances and may submit a new form if there is an increase in the number of personal allowances.⁵²

An employee with two jobs must submit a form to both employers. Because the personal allowances can be claimed only once, the employee must choose where to claim them.⁵³

The employer does not include the employee's other nonwage income in the withholding. However, the amount of estimated nonwage income, such as dividends and interest, reduces the number of additional allowances.

Tax from nonperiodic wage income is withheld at a flat rate rather than at the progressive rate on which the withholding table is based. At the request of the employee, however, the employer may agree to apply a cumulative withholding system.⁵⁴ The employee may also request that this system be applied if his or her wage increases.

Although social security contributions in the United States are not integrated with the PAYE, they are payable together with the PAYE. To some extent, the social security administration is involved in reconciling the payments of each employee and employer. Only the tax administration, however, audits employers.

After filing their returns, employees often receive a refund, as many taxpayers do not claim all the withholding allowances they are entitled to. To compensate for the relatively high withholding, the U.S. tax administration in 1992 began using withholding tables that are somewhat lower than those based solely on the income tax rate.⁵⁵

Depending on the amount of the PAYE, the tax withheld is deposited with the treasury each quarter, month, week, or day using depository coupons preprinted with the employer's

⁵¹*Id.* § 3402(a).

⁵²*Id.* § 3402(f)(2)(B).

⁵³*See id.* § 3402(f)(7).

⁵⁴*See id.* § 3402(h)(3).

⁵⁵*See* 54 Tax Notes 486 (Feb. 3, 1992).

name, address, and identification number.⁵⁶ Payment summaries for each employee are filed with the tax administration each quarter, with the employees identified on the basis of social security number. Annually, employers provide their employees a withholding statement for return filing purposes. A copy of this statement is also forwarded to the tax administration.

Developing and Transition Countries

This section describes the PAYE systems of Chile, Hungary, Indonesia, Kenya, the Philippines, and Russia. These countries were selected because of regional representation.

Chile, Hungary, Indonesia, Kenya, and the Philippines⁵⁷ operate their PAYE in the context of a comprehensive income tax, as do the industrial countries. Russia has implemented a schedular income tax system, in which the schedule for employment income provides final taxation through the PAYE.⁵⁸

Chile

Because of a simple system of only one standard personal allowance (the zero-rated bracket of the rate schedule) and no other deductions, the employee does not need to inform the employer about his or her personal circumstances. The employer simply applies the monthly withholding tables. Although the traditionally high inflation is now close to a single-digit number, the brackets of the withholding tables are defined in so-called monetary taxable units.⁵⁹ Their values in Chilean pesos are adjusted monthly.

The PAYE functions within a comprehensive income tax: the taxable period is the calendar year. The income tax rate is defined in monetary taxable units of which the value in

⁵⁶If the employer's employment taxes for the preceding year are over \$50,000, the employer must make semi-weekly deposits of employment tax; if less than \$50,000, the employer makes monthly deposits. Under the semi-weekly rule, if the payroll date is Wednesday, Thursday, or Friday, the tax must be deposited by the following Wednesday; in other cases by the following Friday. If the employer accumulates \$100,000 in employment tax, the tax must be deposited by the end of the next banking day. *See* Treas. Reg. § 31.6302-1.

⁵⁷Although the income tax of the Philippines has substantial schedular elements, *see supra* ch. 14, note 2, for this purpose it can be considered comprehensive in the sense that wage income is consolidated with other income, such as business income.

⁵⁸This is a simplification of the actual situation, which has changed over time, and which now has moved away from a final tax for employees. While art. 13 of the individual income tax law calls for globalization of income, the precise extent of globalization has varied over time. *See, e.g.*, Presidential Decree No. 2129 of Dec. 11, 1993, which provides that employees with income from several sources whose total income falls within the standard rate bracket do not need to file a return. Article 18 of the law used to be somewhat ambiguous about the filing requirements of employees. It used to state that employees did not have to file returns. However, a sentence was subsequently added stating that this provision did not apply to employees who also had business income.

⁵⁹*See* CHL IR § 43.

pesos is expressed in end-of-year values. All income earned during the year is recalculated in end-of-year values.

The withholding system is a simple PAYE with final withholding on a monthly basis. In effect, the tax period for employees who are not required to file a return is the calendar month.⁶⁰ The employer does not have to adjust the withholding of previous months of the tax year on a cumulative or an end-of-year basis. Differences between tax withheld and final income tax liability must be resolved through return filing.

Although all employees holding a second job are required to file a return, the obligation to file returns is substantially reduced by the following provisions: (1) employees with only one job and no other income never have to file a return⁶¹ (2) a filing threshold applies to other income up to a specified amount⁶² and (3) employees cannot file a return solely to obtain a refund of PAYE.

Social security contributions are withheld from wages and deposited with the social security authorities. The tax and social security administrations each have their own audit programs to ensure proper withholding.

Each month, the employer must transfer the withheld tax to the treasury. Each year, taxable wages and withheld tax for each employee, identified by TIN, must be reported to the tax administration. Each employee receives information about his or her annual wage income and PAYE withheld.

Hungary

Upon commencing employment, the employee must notify the employer of his or her personal circumstances. From this information, the employer determines the employee's entitlement to personal allowances. Other deductions are not included in the employer's monthly withholding scheme. The withholding tables are based upon the income tax rate.

An employee with other income, including other wage income, must file a return with the tax administration at year-end. In this case, a simple PAYE is applicable without cumulation or year-end adjustment. An employee with no other income, but claiming deductible expenses, must file a form with the employer at year-end. In that form, the employee must confirm that he or she received no other (wage) income during the tax year. Based on this form, the employer will "assess" the employee's income through the year-end adjusted PAYE. The employer must make all forms available to the tax administration for audit purposes.

⁶⁰*See id.*

⁶¹*See* CHL IR § 47.

⁶²*See* CHL IR §§ 43, 44, 65.

Through this year-end adjustment, changes in personal allowances, nonperiodic wages, and other deductions are taxed at the withholding level for employees with single wage income. Employees with other (wage) income are assessed by the tax administration after they file a return.

The employer also withholds social security contributions. The contributions are administered separately from the PAYE and are paid to the social security funds. The tax administration is not involved with auditing this withholding system.

Each month, the PAYE withheld must be paid to the treasury, and a return filed to the tax administration. At year-end, taxable wages and PAYE for each employee are reported to the tax administration. All employees, whether assessed by the employer or filing a return, receive information at year-end on their taxable wages and PAYE withheld.

Indonesia

A person who begins a job must inform the employer, in the so-called employee's statement, about the personal allowances he or she is entitled to.⁶³ That statement is valid until the employee's personal circumstances change and a new statement is submitted.⁶⁴

The withholding tables, which are based on the income tax rate,⁶⁵ apply to the relevant pay period only, without cumulative adjustments for tax withheld in preceding pay periods. The noncumulative system, however, is supplemented at year-end through an adjustment of the withholding based on the tax already withheld and the income tax due on the total of taxable wages paid during the tax year.

An employee with any amount of other income, deductions, or a second job must file a return for income tax purposes at year-end.⁶⁶

Employers also withhold from wages a small fraction of social security contributions, which are payable to the social security administration on a monthly basis. The tax administration is responsible for compliance control regarding the PAYE; the social security administration controls the collection of social security contributions.

Each month, the employer deposits the withheld PAYE in the treasury and files a return with the tax administration. Each year, the employer must inform the tax administration of wages

⁶³See IDN IT § 21(III).

⁶⁴See IDN IT § 21(IV).

⁶⁵The PAYE from daily and weekly paid employees, however, is fixed at the basic income tax rate of 15 percent.

⁶⁶See IDN IT § 21(VIII).

paid and PAYE withheld for each employee, the employees being identified by their TIN. The employee receives a statement from the employer for return-filing purposes with his or her taxable wage and PAYE.

Kenya

Employees must complete a personal relief claim form to inform the employer about the personal allowances they are claiming.⁶⁷ On that form, they can also claim other relief, such as deductible life insurance premiums. These deductions, however, must first be approved by the tax administration. To that end, the claim form should be presented for approval to the administration.

During the tax year, the personal relief claims cannot be changed. The employee must wait until the following tax year and include the change in the new form he or she submits for that year.⁶⁸ A failure to complete the claim form will result in withholding without any form of personal relief being granted.⁶⁹ The personal relief takes the form of a tax credit rather than a deduction from the taxable wage and is deducted from the PAYE according to the withholding tables. These tables are based on the income tax rate.

Other income is not included in the PAYE withholding; however, in approving deductible expenses to be included in the PAYE, the tax administration may consider existing other income as it is known to the administration. A second job also does not affect the amount of tax to be withheld in the principal job. In principle, the claim form can be submitted only for the main job; therefore, no relief is granted in the PAYE regarding the second job.

The PAYE is noncumulative for the pay periods of the tax year, a year-end adjustment is not made by the employer, and personal allowances remain unchanged during the tax year. When, because of various circumstances, the PAYE is lower or higher than the income tax due, the employee must (or may) file an income tax return.

An employee's social security contributions are also withheld at source and paid by the employer to the social security fund. The fund is responsible for compliance control regarding the contributions.

The employer registers the PAYE for each employee on tax deduction cards.⁷⁰ At year-end, the employer sends these cards to the tax administration.⁷¹ The administration may use the

⁶⁷For an example of such a form, see Republic of Kenya Income Tax Department, *Employer's Guide to Pay as You Earn in Kenya* 14–15 (1991).

⁶⁸*Id.* at 10–11.

⁶⁹*Id.* at 7.

⁷⁰*See, e.g., id.* at 16–19.

cards for income tax assessment purposes. The employee receives a copy of his or her card for return-filing purposes. The PAYE withheld is paid monthly to the treasury, and a return is filed with the administration.

Philippines

In the Philippines, an employee must submit to the employer a withholding exemption certificate that states his or her personal circumstances and hence the entitlement to personal allowances.⁷² If there is a change in circumstances, a new certificate must be submitted.⁷³ If no certificate is submitted, the withholding is based on zero allowances.⁷⁴

Withholding tables are based on the income tax rate; special average rates are applied to nonperiodic wage income. Although the withholding system is noncumulative with a view to subsequent pay periods of the tax year, the employer is obliged to make a year-end adjustment.⁷⁵ Against the income tax due on the wage income for the entire year, the PAYE withheld until the last pay period will be credited and any remaining tax will be the PAYE of that last period. In theory, the net wage of the last period could be zero, and the employer is responsible for an excess of PAYE over gross wage.

Other (nonwage) income does not affect the PAYE. The employee receives the full amount of personal allowances regardless of any amount of other income he or she may be entitled to. If an employee has more than one job, the personal allowances can be claimed only with the principal employer.

Social security contributions are also withheld from wages, but are deposited with the social security administration. That administration is responsible for compliance control regarding collection and payment of the contributions.

The fact that the income tax liability of the employee is fully covered by the PAYE does not affect the employee's obligation to file an annual return with the administration. The wage content of that return is based on information received from the employer.⁷⁶ At year-end, the employer must report to the tax administration on each employee's wage income and PAYE

⁷¹*Id.* at 9.

⁷²PHL NIRC § 72(d)(2)(A).

⁷³*Id.* § 72(d)(2)(B).

⁷⁴*Id.* § 72(d)(2)(D).

⁷⁵*See id.* § 72(h).

⁷⁶*See id.* § 76(a).

withheld.⁷⁷ The employer transfers the withheld tax monthly to the treasury and files a return with the administration for compliance control. Employees and employers are identified by one unique numbering system.

Russia

In Russia, the PAYE is basically a matter between employee and employer. Employees are not registered with the tax administration. The PAYE is the final income tax for employees.⁷⁸

The employer in effect takes care of the assessment function regarding employment income.⁷⁹ The employee must report all allowances and deductions to the employer, and the employer computes the appropriate withholding. The employer uses the income tax rate designed for employment income. The employment tax rate is almost identical to the tax rate for self-employed persons.

This essentially simple system, however, suffers from the flaw that the income base is compartmentalized in, on the one hand, employment income, and, on the other hand, other taxable income. A person with income from several sources is likely to pay less income tax than one with the same income from only one source. Administrative ease and a not-yet-established market economy, however, are strong arguments for keeping this simple system for a certain time.

The implementation of this PAYE system is far from simple, however. The system seeks too high a level of accuracy for employment income as a whole and for the tax year in total. First, the primary employer is expected to include in the withholding scheme the wages and tax withheld from secondary employment on the basis of information supplied by the employee. Second, the withholding is based on the cumulative system.⁸⁰ Withholding for the current pay period is computed on an annual basis, with a credit for tax already withheld during the tax year.⁸¹ Because the tax administration is not involved, the employer carries the heavy administrative burden of a rather comprehensive system. Whether all employers have the administrative capacity to do so is questionable.

⁷⁷*Id.* § 76(b).

⁷⁸As discussed in note 58, *supra*, this is no longer the case for employees with business income.

⁷⁹RUS IT § 8.

⁸⁰*See id.*

⁸¹*See* RUS IT§ 8.

The employer also withholds social security contributions and transfers them each month to the social security administration. Audits of PAYE and social security withholding are carried out by the tax administration and the social security administration, respectively.

Each month, the employer deposits the withheld PAYE in the treasury. The employer is not required to provide information on individual employees or to submit an annual report to the tax administration.