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Impact of Progressive Taxation on Income Distribution

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ABSTRACT : *Governments can intervene to promote equity, and reduce inequality and poverty, through the tax and benefits system. This means employing a* progressive *tax and benefits system which takes proportionately more tax from those on higher levels of income, and redistributes welfare benefits to those on lower incomes. The progressive principle in income taxation states that the average tax rate should increase with income. Progression has an impact in many areas of economics. The problems, costs and beneficial consequences of this principle have been looked at from many angles*
KEYWORDS *– Progressive Tax, Distribution of Income, ability to Pay, Equity of Tax .*

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I. INTRODUCTION

By nature, taxation may be proportional, progressive or regressive. Progressive tax rates can reduce inequality as a larger amount of tax will be collected from the high income groups. A proportional tax rate causes no change in the relative income distribution in the society. A regressive tax implies a higher burden on the low-income groups; it, thus, tends to widen the gap of inequality. In short, progressive taxation can lead to a reduction in equality and realization of egalitarian goals.

The progressive principle in income taxation states that the average tax rate should increase with income. Progression has an impact in many areas of economics. The problems, costs and beneficial consequences of this principle have been looked at from many angles and are, perhaps, well-known. Blum and Kalven's (1953) Uneasy Case is an early example;2 more recent investigations include those of Bos and Felderer (1989) and Slemrod (1994).

There are two ways to look at the progressive principle. On the one hand, it decrees that a person's average tax rate should rise if his income rises, and on the other that, as between two persons, one having more income than the other, the better-off of the two should pay a greater proportion of his income in tax. In its former aspect, progression affects the person, not least when incomes are growing, and influences his economic decisions. Many of these effects can be examined using the "representative individual" approach, and are not pursued in this review. 3 A fundamental exception is the effect upon work effort; the role of progression in intervening between the distribution of effort and reward is not well understood; we shall discuss this problem. But it is the second implication of progression, that between persons, which yields up the distributive consequences upon which we mainly focus here. An early tracing-out of the distributional measurement issue was provided by Musgrave and Thin (1948), in a paper which is still very stimulating. The thrust of the mainstream of subsequent work has been to achieve a better understanding of the impact of progression across the income distribution, and it is upon this mainstream that we shall concentrate.

It is only under the steeply progressive tax system that the income and wealth inequalities would tend to be reduced, for a heavier direct real burden would fall upon the high income groups under the steeply progressive tax rates. The sharper the progressiveness, thus, the greater would be reduction in the gap of inequalities. A progressive tax system is thus always preferred to proportional or regressive ones in the interest of equitable distribution. A progressive tax rate is, thus, justified on the ground of the principle of ability to pay.

A rich person having a greater ability to pay is taxed at a higher rate and the poor is exempted or taxed at a lower rate in a progressive tax system, so that the gap of inequalities in income and wealth is reduced by levelling down the high incomes. Thus, the greater the element of progressive rates in the tax system, the larger is the scope for improving distribution by reducing inequalities.

There is ample scope for making certain direct taxes (on income and wealth) very progressive which can help in reducing inequalities. For instance, an income tax may be made progressive by adopting a graded scale of tax rates, i.e., larger incomes being taxed at higher rates than the smaller ones.

Moreover, discrimination can also be made between earned and unearned income for taxation. Unearned income may be taxed at a higher rate, since there is no corresponding disutility in earning income from assets or property as in the case of income earned from work. In the interest of proportional sacrifice and equity also, therefore, income from work should be taxed less than income from property.

Further, equity is attained when income tax is levied according to one s ability to pay. For this reason, a very low income, necessary for subsistence and minimum general standard of living may be exempted from tax. On the other hand, a very high income may be taxed at a higher rate and it may also be subject to additional taxes like surcharge.

Similarly, an expenditure tax of progressive nature, too, will cause a reduction in inequalities to some extent. Further, concentration of wealth and power in a few hands can be minimised by a progressive type of general property tax and net annual wealth tax. Similarly, direct tax like capital gains tax is apparently progressive in nature, as it greatly helps in minimising the gap of inequality in the distribution of income and wealth.

Above all, the transfer of wealth upon death is a point at which progressive taxation may achieve desirable effects. A progressive inheritance tax or death duty will help not only in reducing the inequalities of wealth but also the inequalities of incomes generated through wealth.

One of the fundamental ways in which countries can address economic inequality is by redistributing wealth through a well-resourced public provisioning system by means of a just, fair and progressive tax system in place. Direct taxes on income, assets, profits and inheritance are progressive as they depend on the taxpayer's ability to pay, whereas indirect taxes on consumption of goods and services are regressive as they are indiscriminate. The poor and marginalized are especially affected by high indirect taxes as the proportion of one's income going towards indirect taxes tends to be higher at lower levels of income.

The rich and corporations should pay more taxes on their incomes, profits and assets to fund public services for everyone. Currently, two-thirds of India's tax revenue comes from indirect taxes – implying that our incomes, profits and assets are grossly under-taxed while taxes levied on our consumption are some of the highest in the world. Despite this ratio, India suspended the Inheritance Tax in 1986 and abolished the Wealth Tax in 2016, and has recently reduced its statutory corporate tax rate to 25 per cent on companies with a gross turnover up to Rs. 250 crore. The country would do well to consider re-introducing the wealth tax, the inheritance tax and re-establish higher taxes on incomes and profits.

Given the fact that economic inequality has severe non-economic outcomes, working towards bridging the gap in the incomes of the rich and poor will help countries strengthen economic growth, secure a complete realization of human rights for all especially for the most disadvantaged sections of the population, and encourage political representation.

India, income and wealth inequality is deeper than it has ever been in a century. According to Oxfam, the top 10 per cent of India's population holds 77.4 per cent of the national wealth, and the contrast sharpens when the share of the country's top 1 per cent of the population is considered – a whopping 51.53 per cent. While the wealth of the top 1 per cent increased by 39 per cent in 2018, the bottom 50 per cent of the population saw their wealth increase by a mere 3 per cent. Using a different methodology which combined household surveys, national accounts and newly released Indian tax data, economists Lucas Chancel and Thomas Piketty tracked the dynamics of Indian income inequality from 1922 to 2015 – only to reveal that between 1980 and 2014, the top 0.1 per cent of the country's population saw its wealth grow 550 times the rate of the bottom 50 per cent of the population.

In so far as inequality is ultimately about more income and wealth accruing to the rich rather than the rest of the populace, inequality deepens poverty and is intrinsically antithetical to the realization of human rights and gender equality. Inequality impacts material human well-being as well as access to resources and public and private services. It also results in inequality of opportunity through myriad ways, and adversely affects social mobility. Economic inequality drives residential segregation by income, and high-poverty neighbourhoods create lasting disadvantages for families that live there. Socially, inequality is linked to unemployment, crime, violence, humiliation and exclusion. Inequality impacts public participation, representation, public institutions and erodes trust in democratic processes, and thus may fuel corruption and civil unrest.

In the interest of equity, however, progressive inheritance tax may be devised by assessing it on a progressive scale on the amounts inherited by different heirs. Mill, in this context, suggested that there must be a fixed minimum sum beyond which no individual could inherit. But here a complication might arise.

When a person inherits on different occasions, he will be taxed less heavily. So it is thought that it is better if an inheritance tax is graded, not only according to the amounts of inheritance received, but also according to the amount already possessed by the heirs. A loophole generally found in death duty is to avoid it by making gifts in contemplation of death. To check this tendency, a gift tax may also be evolved:

In short, from the foregoing discussion, it follows that a progressive tax system is an important means to reduce inequalities in income and wealth. Dalton, as an empirical measure of the 'degree of progressiveness' in a tax, however, suggests that if a rate of tax t is imposed upon a given income y, the progressiveness of tax may be measured by (dt/dy).

That is to say, the degree of progressiveness of tax is measured by the ratio of relative change in tax rate to a change in income, i.e., dt/dy. Evidently, if dt/dy is positive, taxation is said to be progressive. If dt/dy is

zero, taxation is proportional and if dt/dy is negative, taxation is regressive. The formula, however, measures progressiveness only at a given point on the tax scale, and not on the tax scale as a whole.

For measuring the degree of progressiveness of a tax system as a whole, Dalton evolved a formula as under:
P = d – (d’ + a)
Where p stands for the degree of progressiveness;
d stands for the range of inequality of incomes before tax payment;
d’ stands for the range of inequality of net disposable income, after tax payment;
a is the value of positive constant relating to the allowance made for some increase in inequalities on account of regressive, proportional and even regressive nature of the tax system.

According to this formula, inequality would diminish only if P is positive as well as greater than a. It also suggests that in a modern tax system which is composed of direct and indirect taxes, there are elements of progressiveness as well as regressiveness all at the same time, but the regressive element of some taxes may be more than offset by the progressive element of other taxes making the tax system as a whole progressive, which alone can help in reducing the inequalities of income and wealth in the community.
However, unduly high progressive taxes adversely affect production; therefore, equitable distribution should not be aimed at the cost of economic growth and prosperity.

Further, the distribution of income is also affected by the different kinds of taxes. Progressive income tax, wealth tax, estate duties, etc. ensure equitable distribution, while commodity taxes on essential goods will have a regressive effect which will have an unfavourable impact on distribution.
There is, however, always a dilemma in the matter of a choice between distribution and production. In a developing economy, effects of taxation on production and distribution should be reconciled.

Taxes should be made progressive to ensure equitable distribution, but progressivity should not be so sharp as to adversely affect production and growth. Indeed, in a developing economy, distribution must follow production. There should be economic planning for production and appropriate fiscal measures for equitable distribution, once the production goal is realized.

Progressive taxation was designed to reduce **income** disparity by dis- proportionately **taxing** upper incomes and redistributing the proceeds through the welfare state.
Supporters of the **progressive** system claim that higher salaries enable affluent people to pay higher **taxes** and that this is the fairest system because it lessens the **tax** burden of the poor. ... **Taxes** do not discourage high earners from earning more, and the low **tax** rate encourages the poor to strive to earn more.
A **progressive tax** imposes a higher rate on the wealthy than on the poor. It's based on the taxpayer's ability to pay. Poor families spend a larger share of their incomes on cost of living expenses. They need all the money they earn to purchase and pay for basics like shelter, food, and transportation.
The **progressive tax** system ensures that all taxpayers pay the same rates on the same levels of taxable **income**. The overall effect is that people with higher incomes pay higher **taxes**. ... Low-**income** taxpayers pay not just lower **taxes** overall, but a lower percentage of their **income** within this **tax** system.

Relative Merits of Progressive Taxes:
1. A proportional tax is inequitable, as it falls relatively heavily on poor incomes. A progressive tax is more equitable, as a larger part is taxed on higher incomes it is justifiable just as the law of diminishing marginal utility operates in the case of money. Hence, the disutility of paying a high tax by rich is not as much as that of poor in paying even a low tax. Therefore, the rich should be taxed at a higher rate than the poor.
2. Progressive taxes may be justified on the ground that higher incomes contain surpluses, which have cent per cent capacity to bear taxes. Thus, progressive taxation fully complies with the principle of capacity to bear or ability to pay the tax.
3. Progressive taxes are more economical, as the cost of collection does not rise when the rate of tax increases.
4. Progressive taxation has greater revenue productivity than proportional taxation.
5. The progressive tax system also complies with the canon of elasticity. For, a rise in income is automatically taxed at a higher rate under the system so that revenue increases with economic expansion.
6. Progressive taxes are an engine of social improvement. The strong should assist the weak and the rich should aid the poor. This social morale is well sustained by progressive taxation.
7. Progressive taxation can lead to a better distribution of income and wealth, hence, an increase in general welfare of the community. According to Kaldor, the desire to reduce economic inequalities can be regarded as a justification for adopting a highly progressive tax system.
Some Disadvantages:

Progressive income taxation could impact physical capital formation. A more progressive tax system may reduce the amount of private saving available to finance domestic investment. ... Furthermore, progressive taxation can improve the prospects for growth if it reduces economic volatility.

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