The economic and social role of progressive taxation

Progressive Taxation, Poverty, and Inequality

Knowledge and Understanding

Taxes are the main source of government revenues: they are the funds that keep the government running. A tax can either be regressive or progressive. A regressive tax is one which taxes rich and poor at similar rates. Progressive taxation, on the other hand, is normally meant for increasing tax liability. The fact that progressive taxation has something to do with inequality of incomes has long been anticipated; however, it is only recently that the relationship between income inequality and progression has been investigated in a careful way. According to Doerrenberg & Peichl (2013), progressive taxation implies a decrease of income inequality. Based on the principles of progressive taxation, tax rates are supposed to take more revenue from rich than from poor. Even though the effective rates have varied during recent past, the rich were often taxed at high rates compared to the poor, in line with the principle of progressive taxation.

Not a while back, when attention focused on the poor, poverty, and welfare the escalation of economic inequality was not yet entirely known. Inequality in terms of income was a problem that was less focused on and was normally combined with debates of poverty and redistributive policies alleviating poverty, like progressive taxes and welfare. Furthermore, in the subsequent years of study by economists in rising wage inequality in the 1990s inequality was posed mainly as a divide between those with and without a college degree, or between U.S workers and new working classes of the developing world. From this vantage point, it is remarkable to observe how the attention has dramatically shifted from issues concerning poverty and the poor to those that concern the rich and inequality.

In a capitalist system, some amount of inequality is expected. Perhaps there is some mechanism limiting the amount of economic equality which can be achieved and preventing government policies from equalizing income, despite the efforts. To find this out, it is important to take a look at other democracies to see how much equality they have been able to sustain. An international organization of developed nations analyzed the data of twenty-two member countries in 2008 and found that the ratio of income for the richest 10 percent of the population to the poorest 10 percent was lowest in general in various European countries (Piketty, 2014).

Other studies have also indicated that the society has more economic inequality than any other nations. The question that remains unanswered is why is this the case and can progressive taxation lower inequality. After all, is said and done, various strategies should be considered in the reducing poverty and lowering inequality. The need to resort to taxes and transfers as a poverty reduction strategy will depend mostly on whether the distribution of not reusable profits is mainly driven by changes in the income market distribution or alternative government interventions using tax-transfer equipment.

In case policies could be easily classified as development enhancers or inequality reducers, then the target should focus on growth-inequality objective through the selection of a specific

set of policies that can help in promoting increased development and a second set focused on reducing inequality. Nevertheless, in practice, there are things that tend to be complex not only due to their inherent difficulties of selecting appropriate policies tailored to an individual country's specific situation but also since most cases policies are likely to have an effect on growth and inequality simultaneously and in other situations even producing conflicting results.

Analysis

Progressive taxation maybe successful in raising more tax revenue based on the predetermined indicator of income inequality. Simply put, effective progressivity involves the ration of after-tax GINI to before-tax GINI and approximates the extent to which a specific tax structure results in a shift in income distribution onto equality (Guvenen et al., 2013). This chart, in Krueger’s PowerPoint, presents the Gini coefficient, a measure of inequality for OECD countries before and after taxes and transfers. As shown, the tax code is uniquely modest in the attempt to reduce income inequality

Fig1: Gini coefficient measuring inequality (source: epi.org)

Krueger provides a connection of the income mobility issue, the ability of people to shift between income classes. The graph below provides an illustration of the income inequalities connected with lower interregional mobility (Joumard, Pisu, & Bloch, 2012).

Fig2: Income inequalities (source: epi.org)

An alternative form of intervention in the market is through the provision of subsidies. These are payments made directly by governments to the producers of goods and services. When paid to a producer, a subsidy has the opposite effect of an indirect tax –it is the equivalent of a fall in costs for the producer and results in a rightward shift in the market supply curve (Krueger & Ludwig, 2016). This is shown below. A reduction of subsidy payment will lead to shifting to the left in the supply curve.

Fig3: The effects of introducing a subsidy.

The figure shows that introducing subsidy will result in the fall in price from P to P1 and an increase in the quantity from Q1 to Q1. This is the normal effect on the market when government pay money to producer and may be done for various reasons but particularly to contribute to the equitable distribution of income in this case.