

## TAXES AND ECONOMIC INEQUALITY: AN ANALYSIS FROM THE PERSPECTIVE OF VARIOUS STUDIES

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### Abstract

Taxes play an important role in reducing economic inequality by redistributing income and increasing access to public services. Progressive tax systems, which focus on higher incomes, have been proven effective in reducing economic inequality. Studies reveal that funds collected from progressive taxes can be used to fund social programs such as education, health, and social assistance, all of which contribute to improving the welfare of vulnerable groups. However, the effectiveness of tax policy in reducing inequality largely depends on its proper design and implementation. Poorly designed taxes, such as flat consumption taxes, can be detrimental and increase the economic burden on low-income groups. Therefore, it is important to design fair and progressive tax policies and implement effective systems to ensure compliance and fairness in tax collection. Furthermore, various studies emphasize that tax policy alone is not sufficient to reduce economic inequality. Tax interventions need to be supported by other economic and social policies, such as fair minimum wage policies, inclusive education, and adequate social protection. This combination of policies creates a more inclusive and equitable ecosystem, where every individual has equal opportunities to improve their welfare. Overall, tax is an important tool in addressing economic inequality, but it requires a multi-layered and collaborative approach between various policies. Reforms in the tax system need to be aligned with policies on resource redistribution and improving access to essential public services to support the creation of a more equitable and inclusive society.

Keywords: Taxes, Economic Inequality, Perspective of Various Studies.

### Introduction

Taxes serve an important function in building a nation's economy. As one of the country's main sources of income, taxes enable the funding of various social programs that support economic stability and growth.

Taxes play a core role in reducing the wealth gap through redistribution of income and wealth. By implementing a progressive tax system where wealthy individuals or companies pay higher taxes, the government can raise resources to fund social programs and community services. (Atisa, 2022). These funds can then be utilized to improve the underprivileged's access to education, healthcare, as well as core infrastructure. As a result, progressive taxation can help shrink the gap between rich and poor, improve social mobility, and create more equitable economic opportunities for all segments of society (Zuberi & Teixeira, 2022). (Zuberi & Teixeira, 2021).

In addition, taxes can also be used as a policy tool to promote economic and social justice. A fair tax policy is able to inhibit the excessive accumulation of wealth in a small number of individuals or groups, minimize the extraction of natural resources and the unfair treatment of laborers. (Hsu, 2021). By designing appropriate tax policies, governments can regulate economic activities that tend to be exploitative and destructive, and motivate more responsible and sustainable behavior. Therefore, a strong link between tax policy and economic inequality is essential to create a more prosperous and socially just society (Borzutzky, 2020). (Borzutzky, 2020).

In some developed countries, progressive taxation systems are realized to reduce disparities by taking a larger share of the income of high-income individuals. However, how effective this mechanism is in reducing disparities remains a question mark. Variations in the implementation and adherence to tax policies usually lead to different results across countries (Simet, 2022).

In the context of developing countries, the challenges are even more complicated. Tax policies are often ineffective due to high rates of tax evasion and smuggling. In addition, unfair tax structures can exacerbate existing inequalities. Many individuals and large corporations are able to avoid taxes through various means, while small people and small-medium enterprises are the main burden. (Bhandari & Hanna, 2022)..

However, some critics argue that too much taxation can reduce incentives to work and innovate. They argue that such an approach could hinder long-term economic development. This suggests a dilemma for policymakers in balancing the need for government revenue and economic growth simultaneously. (Weisbach, 2023).

On the other hand, many argue that too much economic inequality can threaten social and political stability. Without a transparent and effective system, a tax policy that is good on paper may fail completely in practice. (Delis et al., 2024).

In addition, globalization has had a significant impact on economic inequality and tax policy. Multinational companies can easily move their profits to jurisdictions with lower tax rates. This adds to the challenge for governments in setting effective tax policies. Therefore, understanding the relationship between tax and economic inequality requires in-depth analysis from multiple perspectives. (Blank, 2021).

In conclusion, taxes do serve an important function in reducing economic inequality, but their effectiveness is highly dependent on their design and implementation. Studies from various perspectives show that comprehensive and coordinated measures are needed to address this challenge. Without the right policies and good implementation, economic inequality will remain an intractable problem.

## **Research Methods**

The study conducted in this research uses the literature research method, which is an approach used to collect and analyze information from various written sources in order to gain an in-depth understanding of a particular topic. This research does not involve field data collection or experiments, but rather emphasizes the review of available literature. (Helaluddin, 2019); (Sanusi, 2015); (Wekke, 2020).

## **Results and Discussion**

### **Tax Theory**

Tax is one of the coercive contributions imposed by the government on citizens, companies, and other entities to fund various national expenditures. Taxes do not provide a direct return to the payer but rather serve the public good such as infrastructure construction, healthcare, education, and more. (Poitras, 2020a). Taxes serve as a means of income equalization and economic control to achieve social welfare. (Simet, 2022).

Taxes can be divided into two main classes based on their nature: first, Direct Taxes: Taxes that are imposed directly on individuals or business entities, and the responsibility for payment cannot be shifted to another party. For example, Income Tax (ITA) is levied on individuals and companies on their income. (Ahmed et al., 2024). Second, Indirect Taxes: Taxes imposed on goods and services, where the taxpayer does not bear the tax directly but shifts it to the consumer. An example is the Value Added Tax (VAT) that is added to the selling price of goods and services. (Ferguson, 2020).

In addition to its nature, taxes can also be classified based on the tax object:

- 1) Income Tax (PPH): Taxes imposed on income earned by individuals or business entities within a certain period of time.
- 2) Value Added Tax (VAT): A tax levied on any increase in the value of a good or service in the production to distribution process.
- 3) Land and Building Tax (PBB): A tax imposed on land and building rights based on the sales value of the tax object.
- 4) Land and Building Acquisition Tax (BPHTB): Tax imposed on the acquisition of rights to land and buildings.
- 5) Export and Import Tax: Taxes levied on goods exported or imported to and from the country. (Mokrov, 2021).

Each type of tax has its own role and characteristics that contribute to increasing state revenue and regulating wealth distribution to achieve national development goals.

Taxes have various important functions in the economy that include the role as a source of budget funding, a regulatory tool, wealth distribution, and stability. The budget provision function is the primary purpose of taxes, which is to provide funds for state spending on infrastructure, education, health, and others. (Caceres,

2023). The regulatory function relates to the use of taxes as an instrument of fiscal policy to control the economy by setting different tax rates to encourage or restrain certain activities. The sharing function aims to minimize income disparities through the redistribution of funds from high-income groups to the less well-off. Finally, the stability function is used to maintain economic stability by regulating the inflation rate, unemployment rate, and growth through appropriate tax policies. (Rodriguez & Wai-Poi, 2024)..

The main purpose of implementing taxes in the economy is to create a source of state spending to run government programs and activities aimed at improving people's welfare. With sufficient funds, the government can build infrastructure, provide public services, and run social welfare programs. In addition, taxes also aim to create income equality and reduce socio-economic inequality. (Aidoo & Donkoh, 2023). Taxes can be used as a tool for equitable distribution of wealth through a progressive taxation system where high income earners pay more. On a broad scale, tax objectives also include economic stability through controlling inflation and maintaining healthy and sustainable economic growth rates. (Poitras, 2020a). Thus, taxes play a vital role in shaping a stable and equitable economic structure.

In general, tax plays a very important role in the economic system with its various functions, including as a source of state revenue, an economic control tool, an instrument to equalize income, and a guarantee of economic stability. (Alves & Guimarães, 2024).. The main purpose of taxes is to provide funds for the national budget needed to run development programs and public services, as well as to reduce socio-economic inequality, and maintain economic stability. (Mankiw, 2021). As such, taxes are a vital tool in creating a fair, stable and sustainable economic structure.

### **Economic Inequality**

Economic inequality refers to the unequal distribution of income or wealth among individuals or groups within a society or nation. It can be seen in significant differences in access to economic resources such as education, health and employment opportunities. Economic inequality is commonly measured through indicators such as the Gini ratio or Gini index, which reflects the extent to which the distribution of income or wealth deviates from a truly equal distribution. (Eydam & Qualo, 2023).. High levels of economic deprivation can lead to a range of negative social consequences, including political instability, social unrest, and a reduced quality of life for large segments of society. Reducing economic deprivation is therefore one of the main focuses of public policy in many countries. (Causa & Hermansen, 2020).

One of the most commonly used indicators to measure economic inequality is the Gini ratio or Gini index. The Gini ratio measures the distribution of income or

wealth in a population and assigns a value between 0 and 1. A value of 0 indicates perfect distribution, where every individual has the same income or wealth, while a value of 1 indicates extreme inequality, where all income or wealth is owned by a single individual or group (Rycroft, 2024). (Rycroft, 2024). The Gini ratio is generated from the Lorenz curve, which depicts the cumulative distribution of income or wealth over the population. The farther the Lorenz curve is from the line of perfect equality, the higher the value of the Gini ratio and the greater the inequality. (Gemicioğlu et al., 2022)..

The coefficient of variation (CV) is another economic variance indicator that measures the variability of data in relation to the average. In the context of income, CV is calculated as the ratio between the standard deviation and the mean of income, which is then multiplied by 100 to get the percentage. (Sukharev, 2022). The coefficient of variation provides information on how much income varies around the mean, with higher CV values indicating higher variance. The advantage of the CV over the Gini ratio is that it is more sensitive to changes in the income distribution over the entire income range, rather than just at the extremes. (Banerjee, 2024).

Income inequality is an issue that is often faced in society. Several indicators are used to measure the extent of inequality. One of the indicators derived from information theory is the Theil Index, which can measure the entropy of income or wealth. (Broulík & Cseres, 2022).. The Theil Index will be 0 if income distribution is equal and the value will be greater if inequality is higher. The advantage of the Theil Index is that it can be decomposed into two components: within-group and between-group inequality. Thus, the Theil Index can provide a deeper understanding of the source of inequality whether it is caused by differences between groups or within the same group. (Poitras, 2020b).

The Palma Ratio is a new indicator that focuses on the income comparison between the richest 10% and the lowest 40%. The Palma Ratio is based on research that shows a large share of global inequality is due to income movements between these groups. The Palma Ratio offers simplicity and a sharp focus on the edges of inequality, making it useful for policy analysis and international comparisons. The higher the value of the Palma Ratio, the greater the inequality with more income collected at the top of the distribution. (Malleon, 2023a).

The Atkinson Index is meant to reflect people's preference for inequality. This indicator differs in that it explicitly takes into account a low tolerance for inequality. The Atkinson index can be adjusted to place more emphasis on certain parts of the income distribution such as low income (Howell, 2024). In this way, policymakers can determine the sensitivity to inequality and choose parameters that match their social values. The larger the value of the Atkinson Index, the greater the perceived inequality in the context of the preference (Auray et al., 2024). (Auray et al., 2022)..

The Income Quartile Share Ratio is an inequality indicator that uses a quartile system to measure the distribution of income within a population. Specifically, it compares the income of the richest quartile with that of the poorest quartile. (Jin, 2023). The calculation is simple and gives a direct picture of the difference in income between the top and bottom of the distribution. A higher ratio indicates greater inequality between the richest and poorest quartiles. Although less complex than other indicators such as the Gini Ratio or Theil Index, the Income Quartile Share Ratio remains effective at providing quick insights into income inequality. (Sattinger, 2022).

Thus, economic inequality indicators such as the Gini Ratio, Coefficient of Variation, Theil Index, Palma Ratio, Atkinson Index, and Income Quartile Share Ratio all provide different ways of understanding and measuring inequality in income or wealth distribution. Each indicator has different strengths and weaknesses and sensitivity to aspects of inequality. Therefore, using multiple indicators together can provide a more comprehensive picture of economic inequality in a society. By understanding the different aspects of inequality through various indicators, policymakers can design more effective interventions to reduce inequality and improve the welfare of the entire population.

### **Relationship between Taxes and Economic Inequality**

Taxes play an important role in reducing economic inequality through income redistribution mechanisms as well as improving access to public services. Progressive taxation systems, such as income tax where the rate increases as one's income rises, have a direct impact on reducing inequality (Mattauch et al., 2022). (Mattauch et al., 2022).. By taxing high-income earners more and then using the funds to subsidize or assist the less well-off, tax policy can help to equalize income distribution. For example, tax revenues can be allocated to social programs such as unemployment benefits, educational scholarships, and affordable or free healthcare, all of which aim to improve the welfare of low-income groups. (Poitras, 2020b).

In addition, consumption taxes can also be designed to minimize inequality. Taxes levied on luxury goods can help reduce consumption of non-essential goods by high-income groups, while tax exemptions or reductions on basic goods can reduce the economic burden on low-income groups. (Barling, 2022). A properly designed consumption tax can be an effective tool to regulate economic behavior and improve income distribution in society. Thus, a tax policy that considers social justice aspects can be an important tool in the effort to reduce economic inequality (Bandyopadhyay, 2022). (Bandyopadhyay, 2021)..

However, the effectiveness of tax policy in reducing inequality depends largely on its design and implementation. Poorly designed taxes or weak tax systems can increase the burden on low-income groups without providing balanced benefits (Malleon, 2023b). For example, flat consumption taxes such as Value Added Tax

(VAT) tend to be regressive because a larger percentage of income is spent by low-income groups on these taxes compared to high-income groups. Therefore, tax reform geared towards progressivity and social justice, as well as strict law enforcement in tax collection, are key factors that determine the success of tax policy in reducing inequality. (Bhai, 2020).

Ultimately, the relationship between taxes and economic inequality is also influenced by the broader social and economic context and other enabling policies that support resource redistribution. Non-tax policies, such as fair minimum wages, access to quality education, and social protection, need to go hand in hand with tax policies to achieve a sustainable reduction in inequality. This combination of strategies can create an ecosystem where every individual has a more balanced opportunity to achieve economic well-being, as well as strengthen social cohesion. Thus, tax policy is not just a fiscal instrument, but also a strategic tool to create a more just and inclusive society.

## **Conclusion**

Taxes play a central role in reducing economic inequality through income redistribution mechanisms and improving access to public services. Progressive taxation in particular has been cited as a powerful tool to shrink the gap by collecting more from those with high incomes and channeling the funds to lower income groups. It can fund social programs such as education, health, and social assistance that can directly improve the welfare of vulnerable groups.

However, the effectiveness of tax policy in narrowing inequality is highly dependent on proper design and implementation. Studies show that poorly designed taxes, such as flat consumption taxes, tend to be regressive and can increase the economic burden on lower income groups. Therefore, it is important to design fair and progressive tax policies and put in place robust systems to ensure compliance and fairness in tax collection.

In addition, various studies also imply that shrinking the economic gap cannot rely solely on tax policy. Tax interventions need to be supported by other economic and social policies such as fair minimum wages, inclusive education policies, and adequate social protection. The combination of these policies can create a more inclusive and fair ecosystem, where every individual has an equal opportunity to achieve prosperity.

Overall, tax is a very important tool in tackling economic inequality, but it requires a multifaceted and collaborative approach between various policies. Reforms in the tax system should go hand in hand with other policies that support the redistribution of resources and improved access to basic public services. Thus, tax policy can be a powerful tool on the road to a more just and inclusive society.

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