

Income Taxation as a Tool of Income Redistribution

Sabitova N.M.^a

Dyudina M.P.^b

^{a,b} Kazan Federal University, Kazan, 420008, Russia
Email: sabitovanm@mail.ru

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Abstract

Many countries use income taxation as one of the essential tools of income redistribution. This paper covers positive and negative effect of the proportional scale of individual taxation introduced by the Russian Federation. The observation suggests that the flat rate increases the social inequality, which, in turn, reflects adversely on the economic growth of the country. The document describes the contribution of the income tax to the budget revenues of the developed countries and provides the data of foreign practice to apply income tax rates. The authors demonstrate the need for the progressive taxation and establishment of a tax-free allowance.

Keywords: Personal income tax, individual income tax, progressive taxation, flat tax rate schedule, minimum subsistence level, tax-free allowance, minimum wage.

1. Introduction

Many countries use the income tax in their taxation system. Nowadays, there are over 200 countries in the world and only 15 of them do not have income tax (UAE, Bahamas, Kuwait, Monaco, Qatar, Somalia, Uruguay and others). Countries with income tax use different scales of income taxation: progressive and proportional. The developed countries employ progressive taxation that enables not only the fiscal function but also smoothing the social inequality. This is implemented in more than 150 countries. The proportional or flat income taxation is acceptable by Russia, Estonia, Latvia, Czech Republic, Bulgaria, Romania and Montenegro. These are not leading countries neither in terms of economic growth nor social protection. Russia has used the progressive income taxation until 2001 and then switched to the proportional one, which is still in use. Switching to the proportional taxation was justified by necessity for taking the illegal salaries out of the shadow, which taxation might contribute to the budget system with additional returns. Such effect took place in the first years after introduction of proportional taxation. Now both the economic publications and political quarters discuss the return back to the progressive income taxation even though there are opponents of such return. Certainly, this tax has both the fiscal and social implication; therefore, the selection of the income taxation scale is rather complicated as the population is socially unequal. Taxes, including income tax, are the tools of redistribution of earnings and wealth in all countries. Therefore, studies are required to identify all pluses and minuses of progressive and proportional income taxation.

2. Theory

Many countries employ progressive taxation with the tax rates ranged from 14% to 75%. Since 2001, the proportional individual income taxation with a rate of 13% is in use in Russia. As envisioned by Russian lawmakers, denial of progressive taxation and implementation of proportional taxation for individuals should take the wages out of the shadow since the employers frequently use the 'envelop' form of payment for labour. Moreover, revenue base of the budgets should increase as well. The opponents of the proportional taxation indicate that one of the key principles of taxation formulated by A. Smith – Concept of Social Justice is violated as the real earnings are not considered in terms of wage size and purchasing ability of population. It should be noted that there have been disputes about the advantages of one or another form of taxation for centuries. Protecting the progressive taxation, the English economist A. Marshall (1842—1924) wrote that "the happiness which an additional shilling brings to a poor man is much greater than that which it brings to a rich one; and that he does good by buying things the production of which raises, in preference to things the production of which lowers the character of those who make them."

At the same time, in many countries the income tax is one of the key sources, which feeds the budgets at different levels. That is to say that the fiscal significance of this tax should not be neglected. The income tax is of great importance in other countries than in Russia, which is supported by statistical data. The income tax returns are the largest budget revenue in many countries. This tax takes the biggest share of tax revenues in Denmark accounting for more than 50% while it varies within 25-35% in other countries. In the Russian Federation, the individual income tax is much lesser accounting for 21% in the revenue and general tax revenue structure of the consolidated budget. Country-wise data are brought in the Table 1.

Table 1. Income tax in the budgets In percentage

Country	Tax revenues of the consolidated budget	GDP share
Australia	47	13
Belgium	34	14
United Kingdom	34	10
Germany	28	9
Denmark	57	26
Ireland	34	10
Iceland	39	12
Italy	27	11
Canada	41	14
Norway	30	12
USA	48	12
Finland	35	15
Switzerland	35	11
Sweden	38	18
Russia	21	4

The matter of income taxation are examined by Russian and foreign economists. Particularly, the issues of progressive income taxation for individuals were studied by such authors as Angyridis, C. [1], Hodgson, H. [2], Schauer, P. C. [3], Dušek, L., Kališková, K., Münich, D. [4], Simonovits, A. [5], Pellegrino, S., Vernizzi, A. [6]. The distribution of individual income tax through the levels of the budget system were covered in papers of such authors as Färber, G. , Kühl, C. , Alt, D. [7], Adam, S. , Johnson, P. , Roantree, B. [8]. The optimisation of progressive income taxation rates and their influence on the standard of population's well-being were analysed by Saez, E. [9], Chahrour, R., Svec, J. [10], Fochmann, M., Weimann, J.[11].

3. Result

Introduction of the proportional income taxation in Russia had some effect as the growth of individual income tax returns for 81.3 billion Rubles at year-end 2001 or 23.7% in real terms. In the subsequent years, the returns yielded about 3.3–3.4% of the Gross Domestic Product versus 2.4% in 2000. The individual income tax share in the Russian Federation consolidated budget revenue has also increased over this time (Fig. 1).

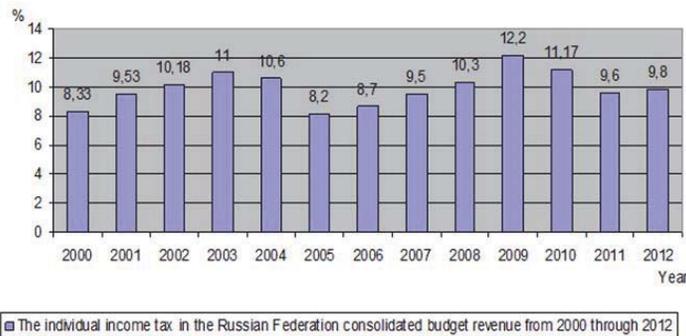


Fig. 1. The individual income tax in the Russian Federation consolidated budget revenue from 2000 through 2012, in percentage

However, the growth of individual income tax over this period was caused not only by switching to another taxation mode. Since 2001, the GDP has shown significant increase in values as well as wages being a GDP component due to increased oil prices. In addition, there were other factors such as increase of income tax rate from 12% to 13%, shifting some revenues from 2000 to 2001, inclusion of service members into the list of taxpayers and others. Nevertheless, introduction of the proportional income taxation in Russia did not solve the problem of shadow income legalisation. Thus, according to A. Siluanov, the Minister of Finance of the Russian Federation, the Russian shadow economy was about 15-20% of GDP in 2013. As a result, the Russian Federation budget system is in arrears of roughly 3 million Rubles of taxes as the business withdraws into the shadow. The Minister estimates the lost individual income tax as 2 trillion Rubles. According to the World Bank, the Russian shadow economy is 3.5 times the economy of the G-7 countries. Moreover, the shadow turnover and illegal money flow have been dynamically growing for 18 years, which was encouraged by low political administration and widely used tax evasion.

The key point of the progressive taxation supporters is implementation of the social justice concept and reduction of personal income inequality. Over the last three decades, the inequality of personal incomes has increased in many countries. In the Russian Federation, the income ratio between 10% of the well-to-do and 10% of the marginal population is constantly increasing and according to the Federal State Statistics Service, it was 16.4 times in 2013. In 2013, 20% of the well-to-do had 47.5% of total cash earnings and 20% of the marginal population – 5.2% only. Russia has a strong lead in USD billionaires in Europe and this despite the fact that there are over 5.5 million jobless people and 15.7 million live below the poverty line. Table 2 provides the distribution of incomes for different groups of Russian population.

Table 2. Distribution of total cash income in Russia

Year	Total cash income	Including 20% group of population, in percentage:					Gini Coefficient
		The first group (with lowest income)	The second group	The third group	The fourth group	The fifth group (with highest income)	
1995	100	6.1	10.8	15.2	21.6	46.3	0.387
2000	100	5.9	10.4	15.1	21.9	46.7	0.395
2005	100	5.4	10.1	15.1	22.7	46.7	0.409
2010	100	5.2	9.8	14.8	22.5	47.7	0.421
2011	100	5.2	9.9	14.9	22.6	47.4	0.417
2012	100	5.2	9.8	14.9	22.5	47.6	0.420
2013 ²⁾	100	5.2	9.9	14.9	22.5	47.5	0.418

The Gini Coefficient is a measure of statistical dispersion intended to represent the income distribution of a nation's residents, and is the most commonly used measure of inequality. It has been estimated to be 0.48 or 41.8% for Russia that is much higher than in European countries and only slightly lower than in South America. According to UN criteria, if it reaches 0.4, it shall be regarded as a red flag, and if the coefficient exceeds this value, it means that the inequality reaches the point where social instability may occur.

Thus, using the proportional taxation will result in steadily increasing gap between the earnings of the wealthiest and the poorest groups while the progressive taxation will help reduce this gap and will generally lead to easing of social tension. There is a belief among the economists that the excessive inequality slows the economic growth down. Different countries used various measures to re-distribute the incomes to solve the problem of inequality. The developed economies succeeded to reduce the inequality on average by about one third using a combination of social transfers and progressive income taxation.

The experience of the developed countries in employing the progressive taxation has shown that multistage rates are in use, i.e. the income splits into fractions with a dedicated rate specified for each fraction. In such countries as Switzerland, Luxemburg, France, the income is split into many fractions; therefore, the transition from one group to another one is gradual and smooth. The progression jumps in other countries, e.g. Poland, Austria, United Kingdom. The lowest the progression level, the simplest the taxation and as a result, the tax administration. Table 3 shows data of some countries that employ progressive income taxation.

The experience of the countries with the progressive taxation is very essential, as it may be useful in Russia bearing the significant inequality of incomes in mind. According to the statistics data, the monthly averaged salary in Russia was 29792 Rubles in 2013 with textile/garment manufacture (13059 Rubles) and agriculture (15264 Rubles) the lowest and financial activity (68704 Rubles) and mineral extraction sector (59012 Rubles) the highest. The Russian wage

level is low. Besides, there is such a definition in Russia as the minimum wage, which was 5554 Rubles as of 1 January 2014 and the best part of employees, primarily, of the government sector get their wages in this amount. Every quarter the Russian Federation government establishes the minimum level of subsistence per capita as well as for social groups. It was 8192 Rubles in the second quarter 2014 with 8192 Rubles for able-bodied population (the Russian Federation Government Regulation No. 905 dated 06.09.2014).

Table 3. Income tax rates in some countries

Country	Progression	Non-taxable income	Tax rates, %
Austria	3-stage	11 000 €	36.5, 43, 50
Belgium	5-stage	6 690 €	25.5 - 53
United Kingdom	3-stage	2 790 £	20, 40, 45
Germany	5-stage	8 130 €	14 - 45
Spain	7-stage	0 €	25, 30, 40, 47, 49, 51, 52
Italy	5-stage	0 €	23, 27, 38, 41, 43
Canada	4-stage	0 \$	15, 22, 26, 29
Luxemburg	18-stage	19 265 €	8 - 40
Netherlands	3-stage	19 645 €	37, 42, 52
Poland	2-stage	0 €	18, 32
Finland	4-stage	13 099 €	25.6 – 49.1
France	7-stage	5 963 €	5.5, 14, 30, 41, 45, 48, 49
USA	7-stage	0 \$	10, 15, 25, 28, 33, 35, 39.6
Switzerland	10-stage (for single people) 14-stage (for married)	0 ZAR	0.77, 0.88, 2.64, 2.97...11.50 1, 2, 3, 4, 5, 6, 7, 8 ...11.50

The 2013 UN-defined living standard rating places Russia between Mongolia and Romania with its position 59. Norway heads the rating; Denmark takes the second place; Canada is the sixth on the list; the USA hit the tenth and the United Kingdom occupies the thirteenth position. In view of the aforesaid, we believe social justice is the question of the day in Russia; therefore, we think that the progressive income taxation could reduce the income difference. However, some economists believe that the Russian progressive taxation shall be applied to excess profits only where their size should be excessive in fact. We support this alternative. The question is only at what level of wages the progressive taxation should be applied. Furthermore, the personal income exemption is being discussed, which is fair in the context of social justice. The majority of Russian economists tends to believe that the personal exemption should be equal to the minimum level of subsistence. 1.7% of Russian population earn half the subsistence level and 9.3% earn an income equal to the amount of one subsistence wage. Therefore, if the personal exemption is set at the subsistence level, 11% shall not pay the income tax. However, we understand that the problem of illegal or envelop salary will rise. It will need strengthening the tax control and increasing the tax administration costs.

4. Conclusion

We believe that the progressive income taxation may lower the social inequality and reduce income difference and poverty in Russia. Tax rate progression in Russia may be applied starting with an annual income in excess of 12 million Rubles. This taxation should be subjected to multistage progression as used in the developed countries. It is a good practice to establish a personal income exemption not lower than the subsistence level taking the aggregate income and the family size into consideration. Appropriate measures should be taken to enhance income tax administration and responsibility of employers who pays the envelop salaries. These measures shall not result in reduction of income tax returns to the budget system, as this tax is the dominant one that feeds the budgets of the Russian Federation regions and local budgets.

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