

Essays on Personal Income Taxation and Income Inequality

Dissertation Abstract

Countries throughout the world have made a major shift toward flatter personal income tax (PIT) schedules over the last two decades. Many have argued that these flatter schedules may have reduced the ability of the personal income tax to redistribute income. If this conclusion is correct, it casts serious doubts on the policy shift towards linear PIT schedules taking place in developing and transitional countries. Although very intuitive, it is not immediately clear that flattening personal income tax schedules will increase inequality. This potentially counterintuitive result is especially possible in the presence of tax induced behavioral responses such as evasion. Therefore, arguing for or against the adoption of a flatter PIT schedule requires a very detailed understanding of the relationship between personal income taxes and income inequality.

This dissertation comprises two essays that attempt to address this issue. The first essay seeks to determine, empirically, the relationship between the structural progressivity of personal income taxes and net income inequality, with a special emphasis on the differential effect of progressivity on observed vs. actual inequality. The key prediction of our theoretical framework is that progressivity affects observed inequality differently than it does true inequality, and that the difference increases with the extent of tax evasion and its responsiveness to tax changes, *ceteris paribus*. We test this hypothesis using a country-level dataset of Gini coefficients calculated separately for gross income, net income, and consumption. We also develop and estimate comprehensive, time-varying measures of structural progressivity of national PIT systems over the 1981–2005 period.

The results show that while structural progressivity reduces observed inequality in reported gross and net income, it has a significantly smaller impact on true inequality, approximated by consumption-based measures of GINI. We show theoretically and empirically that, under specific conditions, tax progressivity may increase actual inequality, especially in countries with weak law and order, and a large informal nontaxable sector.

Essay two extends Essay I by decomposing the different channels through which taxes affect income distribution. The simulation focuses on the distributional impact of the Russian flat tax reform of 2001 using data from the Russian Longitudinal Monitoring Survey. I use a micro simulation counterfactual analysis to decompose the change in the distribution of net income into a direct (or tax) effect and an indirect (or behavioral) effect. I find that the direct effect led to an increase in net income inequality while the indirect effect reduced net income inequality. The results also show that the indirect effect is larger than the direct effect thus leading to an overall decline in income inequality.

Since the indirect effect includes both tax-induced and non-taxed-induced responses, I identify the tax-induced portion of the indirect effect using the evasion and productivity

elasticities. The results from this exercise reveal that the impact of the tax-induced indirect effects, and the evasion effect in particular, depend on the measure of income used. While the evasion response had a positive effect on (or increased) reported net income inequality, it had a negative effect on consumption based measures of net income inequality. Therefore, to the extent that consumption approximates true income, these results demonstrate that the PIT affects true income inequality differently than it does reported income inequality and that the PIT may even be positively related to true income inequality.

The policy implications of these results are very significant. Countries that have very large informal sectors may not be restricted by the equity efficiency trade-off. This further implies that tax policies aimed at flattening PIT schedules cannot be dismissed purely on the basis of equity considerations.