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Progressive Taxation and Inequality: Experience of Eastern Europe and Central Asia

Natalia Pushkareva · Monday, July 31st, 2023

Progressive Income Taxation, Inequality, SDG 10 Reduced Inequalities

It is generally believed that a progressive personal income tax is an effective instrument for enhancing income redistribution and, hence, reducing income inequality, at least in the short run[1]. Often, international organization advise switching to progressive taxation of income as one of the world's best practices to reduce inequality. However, in some cases a switch from a flat income tax to a progressive one does not result in reduced income inequality as predicted by economic theory. The same is true for switching from a progressive income tax to a flat PIT: an expected increase in income inequality does not always follow automatically.

In three Eastern European/ Central Asian countries, the introduction of progressive taxation of income or switching back to a flat personal income tax had interesting results: **Albania** returning to a flat income tax rate in 2007-2008, **Moldova** replacing progressive PIT rates with a flat one in 2018, and **Turkiye**, where a progressive personal income tax was introduced in 2019. In **Uzbekistan**, introduction of progressive taxation has been discussed several times but not yet implemented. What are some of the key factors that have an impact on the effectiveness of progressive income taxation for enhancing redistribution?

First factor: The Tax Mix

Albania returned[3] to a flat tax scale in 2007 for income and in 2008 for wealth to deal with informality, attract FDI (taxes were also imposed at a low rate) and promote economic growth, before re-introducing progressive taxation in 2014[4]. For income, there was an untaxable minimum of 10.000 lek, after which a flat scale of 10% was to be applied. The critics of the reform predicted that inequality would rise as a response to a flat income tax rate. However, it did not. The inequality trend did not change until the 2014 crisis hit (according to World Band data[5]).

According to recent analysis[6] performed by the World Bank, the limited redistribution effect of the Albanian tax system is largely connected to the country's heavy reliance on VAT for revenue collection. While VAT remains a major revenue-raiser across the globe, provides stable revenue streams and is relatively easy to collect, in some cases as in Albania it can have a poverty-increasing impact due to the regressivity of the tax. The problem can nevertheless be addressed through a thoughtful, pro-poor design of the tax.

When, *in the early transition stage, Albania relied on progressive income taxation, inequality still* *remained high, according to* Professor Selami Xhepa *of the University of Tirana*[7]. The concentration of wealth in Albania is often interconnected with concentration of political power, and as political elites are often the ones benefiting from inequality, they have little incentive to change the situation, redistribute income and wealth more effectively and govern more transparently.

Second factor: Macroeconomic situation

A progressive personal income tax scale was introduced in **Turkey** in 2019[8]. The reform is still fresh and the country's Gini index has not been updated yet. However, the World Inequality Database has information for 2020 and 2021 according to which in 2020 the income inequality between the top 1% and the bottom 50% grew in the country, whereas it reduced a little in 2021[9]. The trend of recent years is non-linear.

Turkey suffers from the highest inequality level of all countries classified as European. Right before the 2020 crises hit, notwithstanding several years of considerable economic growth and macroeconomic stability, the level of income inequality in Turkey resembled that of most unequal countries of Latin America and Sub-Saharan Africa[10].

The political situation has been very challenging in Turkey in recent years, and the country suffered from inflation at a rate of over 80%. The unemployment rate remains high as well. Without doubt, in such conditions redistributive impact of the tax system stays limited.

Third factor: External Shocks

In **Moldova** a flat income tax of 12% replaced a progressive PIT scale in 2018[11]. The country's Gini index, however, remained at the same level[12]. Several reasons explain the modest redistributive effect of the reform so far, the main being its coinciding with the COVID-19-induced pandemic followed by the war in Ukraine. Moldova is one of the countries facing the most drastic impacts of the global cost-of-living crisis[13] catalyzed by war in Ukraine, which, depending on the duration of the war and its territorial coverage, could cost Moldova between 2-10% of the country's GDP[14].

Fourth factor: Informality

Another important factor to take into account when considering pros and cons of introducing progressive taxation is the level of informality in the economy. One example is **Uzbekistan**, a country with informality level of at least 50%. Uzbekistan has been considering introducing progressive taxation of income and wealth several times but has decided not to due to worries about the impact the reform would have on compliance and revenue collection.

In summary:

- Macroeconomic factors do play a role and should be taken into account when assessing the redistributive effect of tax policy reforms. For instance, in times of crisis the inequality level can be expected to rise, and the assessment of the tax system's performance in addressing inequality should be adjusted with that in view.
- In some contexts, it might be de-facto impossible to tax the wealthy due to their close connections to corrupted political and/or criminal elites, lack of rule of law and weak institutions.
- In some countries, the barrier for effective implementation of a progressive income tax lays in the

fact that tax administrations cannot access some information on real / full income of the rich, and thus cannot tax them effectively. The wealthy taxpayers often enjoy multiple opportunities for tax avoidance and evasion, including disguising the real type of their income, transferring it to offshores, bank secrecy, etc. In some cases, such data becomes very difficult, or even impossible, to trace, and home tax administrations simply cannot access it to enforce relevant tax legislation effectively due to lack of technical capacity.

- Where a country is facing significant levels of informality, it might be a bigger problem, and a flat income tax rate might be preferrable.
- Finally, some factors might be specific to the country or the region in question, and understanding of the local context is critical for the impact assessment. Progressive taxation of income and wealth can be a powerful tool for nurturing more equitable and stable societies, but such policy decisions are very context-depending and must not be recommended automatically without proper consideration.

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[1] see, for instance: Christopher Hoy and Chiara Bronchi, "Why does the progressivity of taxes matter?", World Bank Blogs, 09 November 2022, https://blogs.worldbank.org/governance/why-does-progressivity-taxes-matter, accessed on 10 May 2023

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