

APPROACHES TO FAIR AND EFFICIENT DISTRIBUTION OF THE TAX BURDEN IN TERMS OF INCOME TAX

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Introduction. Defining and maintaining the optimal tax burden for each country has been and remains a topical issue. Failure to maintain the optimal level of the tax burden for a long period of time can cause significant damage to the economy, which is a consequence of the reduction of tax revenues of the state budget, the slowing down of the pace of development of various branches of the economy. In determining the optimal level, the correct combination of the principles of fairness and efficiency of taxation is extremely important. In recent years, the progressive income tax system in Armenia was replaced by a flat system, due to which a number of problems appeared, as citizens with high and low salaries are taxed at the same rate of income tax, and as a result of the increase in indirect taxes, the tax burden for socially disadvantaged people has grown even more. All this has led to an unfair distribution of the tax burden. The purpose of this article is to find out which of the three income tax systems satisfies the principles of justice and to propose such solutions, through which the tax burden will be distributed fairly and equally for people in different social groups.

Methodology. Research methods are chosen based on the specifics of the object and the set problems. The research used the methods of scientific cognition, particularly abstraction, analysis, observation and logic, as well as comparison. The theoretical and informational basis for the research was the works of foreign and domestic economists, scientific articles, reports published by various international organizations, the tax legislation of the Republic of Armenia, as well as other materials related to the researched topic. In order to understand the features of different income tax systems and to carry out the research accurately, first of all, the principles of fairness and efficiency of the tax burden were compared. The characteristics of the principles of horizontal and vertical justice were analyzed. In order to assess the fairness and efficiency of taxation, the amount of income tax for citizens in different income groups was calculated in case of application of three different taxation systems. In order to study the international experience, the methods of comparison and synthesis were used, presenting proposals on their localization in Armenia. Such a methodology allows for a comprehensive analysis and a more complete picture of the fair and equitable distribution of the tax burden.

Literature review. As early as 1776, Adam Smith addressed the concepts of the efficiency and justice of taxation in "An Inquiry into the Nature and Causes of the Wealth of Nations" [Smith, 1997, 28-30]. The concept of "justice" is created through the "invisible hand" of the state, especially in the conditions of a free market economy.

The necessity of applying the principle of justice of taxation has not lost its relevance even in the 21st century, because in order to form a democratic society, it is necessary to take into account the various forms of manifestation of the institution of law, with the supremacy of the principle of justice.

This concept was further developed by John Rawls in the framework of his published study "A Theory of Justice" [Rolls, 1995, 534].

His point of view is that the concept of "justice" perceived by human reason is characterized by the establishment of public institutions. John Steward Mill, being a supporter of positive economics, separated the concepts of efficiency and justice from each other [Makasheva, 1995, 27-29].

It should be noted that proponents of normative and positive economics have always argued about the concepts of justice and efficiency, because some of them simply did not distinguish these concepts. Proponents of liberal economics rely on the principle of "minimum state intervention".

Arthur Okun's "Equality and Efficiency" (1975) argues that the human pursuit of equality always limits efficiency or vice versa. That is, these two concepts are inversely relative quantities [Bondarenko, 2006, 125-127].

While making theoretical formulations in the article, I used also the works of famous American economists William Baumol and Alan Blinder.

The issues of tax policy and tax burden have always been and remain the focus of attention of Armenian economists L. Barkhudaryan, V. Bostanjyan, T. Manaseryan, B. Yeghiazaryan, G. Kirakosyan, V. Harutyunyan, H. Ghusyan, A. Markosyan and others.

Scientific novelty. Conceptual approaches to fair and efficient distribution of the tax burden in terms of income tax were compared and evaluated in the study, as well as in a comprehensive and complete form, economic evaluations were given regarding the preservation and violation of the principle of justice in different taxation regimes. Regulations have been proposed and substantiated, through which it will be possible to distribute the tax burden more fairly and efficiently in case of application of flat and progressive income tax systems.

Analysis. Since the income tax directly affects the decisions to be made by individuals and legal entities about investments, savings and work, it is important to find out:

- the distribution of the tax burden is efficient in terms of the state,
- distribution of tax burden is fair in terms of economic entities and individuals.

Thus, when looking at tax policy from an efficiency perspective, it is theoretically believed that a flat taxation system reduces the use of tax arbitrage and also increases the participation of highly qualified individuals in the labor market, especially when labor supply is highly elastic. The possibility of using tax arbitrage in the republic is mainly a result of ineffective tax administration, and the labor supply has very low elasticity, because the number of qualified professionals in all fields is very small.

The supposed benefits of a flat taxation system are countered by the factor of the fairness of the tax system, that is, the fairness of income redistribution. Among them are the following principles of justice:

- horizontal,
- vertical.

From horizontal justice point of view, those who receive the same level of income should bear the same tax burden, and from the point of view of vertical justice, those who receive a large income, that is, those who are more solvent, should bear a proportionally greater tax burden. A flat income tax mechanism does not ensure this [Baumol & Blinder, 2019, 222-233]. Therefore, a dilemma arises for governments in different countries regarding the choice of tax burden distribution mechanisms: that is, which is more appropriate economic efficiency or fairness of taxation?

While assessing tax systems and taxes from the point of view of fairness and efficiency, it is important to present them in the analysis in a comprehensive, comprehensive and complete form, where calculations with progressive, flat or regressive income tax scales should be taken into account. Table 1 summarizes the incomes (in the form of wages) of individuals with three different incomes under three different payroll tax systems.

1. according to the progressive scale,
2. according to the flat scale,
3. according to the regressive scale.

Let's take 3 citizens whose salary is

- 150,000 drams
- 500,000 drams
- 2,500,000 drams

According to Table 1, under the three taxation systems, high wage earners pay more taxes than the rest, which was shown in the tax amount column. Therefore, it seems that the principle of solvency works in all three cases. Thus, in the case of progressives, the average interest rate for high earners is higher than for **low** earners. In the case of equality, everyone is taxed at the same rate, and therefore both average and marginal tax

rates are equal for all income brackets. In the regressive case, the average rate is smaller for high-wage earners than for low-wage earners.¹

Table 1. Income tax accounting with three taxation systems²

Salary amount	Progressive taxation			Flat taxation			Regressive taxation		
	Tax amount	Tax rate	Average rate	Tax amount	Tax rate	Average rate	Tax amount	Tax rate	Average rate
150,000	34,500	23%	23%	34,500	23%	23%	34,500	23%	23%
500,000	132,500	28%	26.5%	115,000	23%	23%	104,500	20%	20,9%
2,500,000	732,500	36%	29.3%	575,000	23%	23%	489,500	17%	19,6%

Basically, in the case of the average salary and the tax rates operating in different scales, no significant differences were observed, but in the case of a flat system, employees lose their internal interest, because the tax rate does not change when they work more or less. Therefore, a question arises. From the point of view of vertical fairness (which is characterized by the principle of ability to pay and indicates solvency from a financial point of view), which taxation system is better?

Many countries have applied and later abandoned the regressive system because it is not completely fair. From the point of view of the fair distribution of the tax burden, the progressive scale of taxation has become very popular and is used in some developed countries, which not only carries an element of the principle of justice, but also the principle of efficiency. The main debate is between the choice of progressive and flat taxation systems. Basically, the supporters of the principle of justice tend to the progressive system, because from the point of view of both horizontal and vertical justice, this system is considered to meet the definitions³.

The flat system does not meet the definitions of both horizontal and vertical justice concepts, because in the horizontal case (those in an equal position should be taxed equally), when the level of income is considered as a unit of measurement of status, then we see that those with higher incomes compared to those with less are not in an equal position but are taxed at the same equal rate. And from the point of view of vertical justice (solvency), in the case of a flat taxation system, as can be seen in Table 1, when looking at average rates, both high and low wage earners are taxed at equal marginal and

¹[https://socialsci.libretexts.org/Bookshelves/Economics/Book%3A_Economics_\(Boundless\)/16%3A_A_Taxes_and_Public_Finance/16.3%3A_Progressive_Proportional_and_Regressive_Taxes](https://socialsci.libretexts.org/Bookshelves/Economics/Book%3A_Economics_(Boundless)/16%3A_A_Taxes_and_Public_Finance/16.3%3A_Progressive_Proportional_and_Regressive_Taxes)

² Calculated by the author

³ <https://okpolicy.org/resources/online-budget-guide/revenues/an-overview-of-our-tax-system/characteristics-of-an-effective-tax-system/>

average rates (which undermines the principle of vertical justice. Proponents of flat taxation mainly justify their preference based on the criterion of taxation efficiency.

A flat system is used in Armenia, which has led to even more income polarization. As stated in the justification of the flat income tax law project, the purpose of this change is to contribute to the development of the economy, to increase competitive advantages and to increase export volumes.¹ There are problematic issues here. As mentioned in the "Global Competitiveness Index"², which is measured among around 140 countries, Armenia is on the 73rd place in that list. The index is determined by calculating 98 different coefficients. By averaging these 98 factors, it is presented which countries have competitive advantages compared to others.

One of the above-mentioned 98 coefficients is "labor taxation", which includes not only income tax, but also taxes in the form of social contributions. According to this index, Armenia was already in the first place, that is, those taxes in Armenia were a smaller burden for business as a hindering factor compared to other countries. For example, Germany, which is the 3rd in the world in terms of the overall indicator, is in the 97th place with the same "labor tax" factor. This means that the explanation that a businessman will gain a competitive advantage by reducing taxes is not a justified approach, because the real competitive advantage occurs when productivity increases. Armenia is 3-4 times behind other countries in terms of productivity in any field. In this sense, the purpose of using a flat system does not coincide with the action .

The introduction of a flat system is not preferable, because an attempt was made to use the Georgian model, where the concept of a tax-free threshold is not applied, but in the Baltic countries, for example, it is applied. Russia, Serbia, and Ukraine are among the countries with a flat taxation system. These countries use deductions from taxable income, which also mitigate the vertical unfairness caused by equalization.

Those who earn up to 150,000 drams barely cover their primary needs. If the non-taxable threshold is not applied, then both the person who earns 150,000 drams is taxed at 20%, and the person who receives 1 or 2 million drams. In this case, the principle of vertical justice is violated, where taxation according to purchasing power is important. The purchasing power of a person earning 150,000 drams is much smaller than that of one or two million drams, so this approach is definitely not fair. Therefore, it would be correct to apply the concept of non-taxable threshold in the case of a flat system. For example, in 150,000 drams, it can be applied to the extent of the poverty threshold. From

¹ <https://www.e-draft.am/projects/1475/justification>

² https://www3.weforum.org/docs/GCR2018/05FullReport/TheGlobalCompetitivenessReport2018.pdf?_gl=1*1vp7nvp*_up*MQ..&gclid=EAIaIQobChMI1oTirtae-wIVU7vVCh0Ckw6DEAAYASAAEgLSH_D_BwE

the point of view of the equal distribution of the tax burden, it would also be correct to introduce additional provisions in the law, for example, in case of having children, an additional 50,000 drams may not be taxed. The current level system does not provide this. On the other hand, the reduction of the burden on direct taxes was imposed on indirect taxes, particularly excise taxes. In this case, the person earning a salary of 150,000 drams will be less able to make purchases, because the increase in the excise tax burden will lead to inflation. It is obvious that even a small increase in prices will have a significant impact on citizens earning 150,000 AMD, which is more than 400,000 people. The former progressive system was, of course, not perfect, as the ranges between tax rates were very large. 23% tax was followed by 28%, then 36%. This could not be considered a good system. Therefore, this regime could be reformed, instead of moving to a flat version, which is not justified from the point of view of justice.

Conclusion. Analyzing the advantages and disadvantages of progressive and flat taxation systems, it can be concluded that in the case of flat taxation, the principle of justice is completely violated, and in the case of progressive taxation, tax loopholes may appear and cause economic inefficiency. The choice between progressive or flat systems depends on which principle of tax burden distribution is preferred: fairness or efficiency. In the current conditions of the shadow economy, the logic of the transition from progressive to flat is that capital should be taxed less and consumption should be taxed more.

Thus, we propose to apply the progressive taxation system, which is the most consistent with the principle of justice among the existing systems, however, it is necessary to reduce the ranges of 23%, 28%, 36% rates used before. And in case of leaving the current flat system, in order to balance the distribution of the tax burden, it is proposed to establish a non-taxable threshold at the level of poverty in the case of citizens receiving a salary of up to 150,000 drams.

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Approaches to fair and efficient distribution of tax burden in terms of income tax

Key words: tax burden, horizontal justice, efficient distribution, vertical justice, tax administration, tax loopholes, tax system, taxation regime

The article discusses the advantages and disadvantages of applying income tax in three different regimes. The features of taxation of citizens with different levels of income were calculated and compared in case of application of progressive, flat and regressive system. Economic evaluations were given regarding the preservation and violation of the principle of justice in three taxation regimes. The article argues that in the case of applying a flat income tax system in Armenia, high and low wage earners are taxed at the same rates, which is certainly an unfair approach. Due to legislative changes, the tax burden of the socially disadvantaged class has increased, as the rates of excise taxes have also increased. The tax burden is unfairly distributed, due to which the social polarization in the country deepens. As a result of the study of international experience and taking into account the features of our country's economy, proposals were made that will contribute to the more fair distribution of the tax burden in terms of income tax. In order to distribute the tax burden fairly, it was proposed to review the current income tax system in the Republic of Armenia, in particular, to apply the former progressive system, but reducing the differences between the rates, and in case of leaving the current system, to set a non-taxable threshold. It has been presented under which regime the probability of the occurrence of tax loopholes is the greatest.