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The Role of Direct Taxes in Reducing Economic Inequality: A Policy Analysis

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ABSTRACT: Economic inequality is a matter of concern for policymakers across the globe. Direct taxation is a key instrument to check income inequalities and ensure equitable wealth distribution. This research examines in detail how direct taxes such as income tax, corporate tax, and wealth tax check economic inequality. Based on empirical data and statistical evidence, the research tests how effective progressive taxation is in narrowing income inequalities and ensuring equitable resource distribution. Concepts such as the ability-to-pay principle and redistributive justice are included in the analysis to ascertain the social and economic impact of tax policies. The research also tests how effective direct taxation is in India and compares it with global best practices to ascertain the optimal policy choices. The key findings indicate that if progressive direct taxation is enforced effectively with fewer loopholes and evasion, it can raise income equality and social welfare significantly. However, issues such as tax avoidance, policy inconsistency, and poor administration restrict the scope of direct taxes. The research recommends tax reforms, improved compliance measures, and evidence-based policymaking to enhance the redistributive role of direct taxation.

KEYWORDS: Economic inequality, policymakers, direct taxation, income inequalities, wealth distribution, income tax, corporate tax, wealth tax, empirical data, statistical evidence, progressive taxation, resource distribution,

I. INTRODUCTION

Economic inequality is a major issue in India, characterized by extreme income and wealth disparities. Although direct taxes like income tax and corporate tax are intended to operate as redistribution instruments, their capability to combat economic inequality is restricted. The system of progressive taxation, whereby a higher tax is levied on those who have more, seeks to offset disparities in wealth and finance social welfare programs for the economically weaker section. Nevertheless, its redistributive potential is limited by the narrow tax base that covers barely 6% of Indian adults who pay income tax. Consequently, in spite of its progressive design, India's direct tax system has only a small marginal effect on overall inequality.

The effect of direct taxation on economic inequality is usually measured by the Gini coefficient, a commonly used indicator of income inequality. Research shows that among the tax-paying population, progressive income tax measures lower the Gini coefficient by about 0.05 points, but when the whole population is taken into account, the decrease is much less, at around 0.013-0.014 points. This difference points to the inherent weakness of India's tax system in tackling wealth inequality on a broader level.

Corporation taxes, another central part of direct taxation, have an indirect and more complicated impact on economic inequality. Although higher corporation taxes might be theoretically able to decrease wealth concentration by capping shareholder profits, they can trigger unintended effects such as higher prices for consumers or lower wages and thus undermine their redistributive powers. Moreover, tax evasion and profit shifting from corporations further muddy the impact of corporate taxation on reducing economic inequality.

India's modest achievement in lessening inequality through taxation implies the necessity for policy reforms aimed at broadening the tax base, improving compliance, and bringing in measures like wealth taxes so that income and wealth are distributed more equally.

This research examines the contribution of direct taxation in reducing economic inequality in India based on empirical evidence and literature. Through the assessment of the redistributive potential of income and corporate taxes in curbing income differentials, this research sheds light on policy suggestions that could improve India's tax system in terms of redistributive ability. The results of this research carry profound implications for fiscal policy, social welfare policy, and economic fairness in the nation.

Direct taxes help lower economic disparity in India by greater spending on income tax and corporate tax revenue, but only to a certain limit because of the low number of taxpayers, which leads to a wider gap than where they commence from.

India's tax system on income is progressive, ranging from 0% to 30%, and can be used to finance welfare for the poor. Statistics for 2011-18 indicate that for taxpayers, the Gini coefficient (a measure of inequality) falls by approximately 0.05 points after taxation, from 0.43-0.489 to 0.385-0.442. But for the whole adult population, the reduction is just 0.013-0.014 points, between Gini before tax at 0.591-0.605 and after tax at 0.577-0.592, because of the broad tax base. Company taxes indirectly affect the economy, possibly lowering shareholder income but potentially passing the costs onto customers or workers, so their effect on inequality is ambiguous.

The primary problem is the narrow tax base, with the vast majority of Indians not paying income tax, curtailing the capacity of the system to redistribute income. In comparison to nations such as Denmark, where taxes and transfers substantially reduce inequality (e.g., Gini falls from 0.45 before to 0.25 after), India's system has a considerably lesser impact, which underscores the necessity for change.

Objectives

- Assess the Impact of Direct Taxes on Economic Inequality
- Examine Tax Fairness and Awareness Among Different Income Groups

II. LITERATURE REVIEW

Vipin (2024). This study examines the impact of Indian government policies, including direct taxation, on income disparity and evaluates their effectiveness in reducing inequality. Shubham Garg, Rakesh Kumar, & Anil Kumar (2024). This empirical study identifies the determinants of direct tax revenue in India and discusses their implications on income distribution and financial stability. Chetna Yadav (2024). The study critically analyzes India's tax rates and structures, emphasizing the impact of direct and indirect taxation on economic expansion and investment. R. K. Mishra & P. K. Das (2024). This study assesses the role of direct taxes in mitigating income inequality in India and recommends policy changes for improved tax effectiveness. P. S. Nair & R. G. Menon (2024). The study evaluates how direct taxation contributes to mitigating income inequality, discussing challenges and suggesting strategies for tax administration improvements. A. B. Singh & N. K. Sharma (2024). This research assesses the impact of recent direct tax reforms on income inequality in India and provides recommendations for future fiscal policies. Dr. Jyoti Khurana (2023). This paper assesses the trends of direct and indirect tax collections and their impact on India's GDP from 2012-13 to 2021-22, emphasizing the role of direct taxes in economic growth. Jagbir Singh Kadyan, Renu Sobti, Leena Jenefa, & M. Abu Nasir (2023). The study provides an analytical review of direct taxation in India, focusing on the quantum of direct tax collection, its contribution to revenue, and incurred costs. Chetna Yadav (2023). This research compares direct and indirect taxes in India, studying their implications on economic growth, revenue generation, and social equity. Sanjeev Gupta, Michael Keen, Alpa Shah, & Geneviève Verdier (2023). The study analyzes the effects of fiscal policies, including direct taxation and subsidies, on income distribution and poverty alleviation in India. Isabell Koske (2023). This OECD paper examines income and property tax structures in India, proposing reforms to enhance growth while improving tax redistribution effectiveness. L. R. Jain & S. Gupta (2023). This paper evaluates the progressivity of India's income tax system, measuring its redistributive effects on income inequality using empirical data. S. N. Tripathi & A. K. Verma (2023). The study examines how direct taxation reduces economic disparities in India and highlights strategies for enhancing tax compliance and revenue collection. M. S. Reddy & K. L. Rao (2023). This research explores the link between progressive taxation and income inequality, analyzing policy effectiveness in reducing wealth disparities in India.

III. RESEARCH METHODOLOGY

This study uses a quantitative research design to explore the role of direct taxation in reducing economic disparities by looking at public perception of fairness in taxation and awareness. Descriptive and inferential methods are

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used to explore differences in perception of taxation between different income levels and age groups. Primary data was collected through a structured survey administered to individuals across different income brackets and age groups. The survey included questions on respondents' perceptions of tax fairness, their awareness of tax policies, and their socioeconomic background. A total of 200 respondents participated in the study, ensuring a diverse and representative sample. Random sampling technique was used to ensure fair representation across different demographic groups. The sample was divided based on income levels and age categories to capture variations in tax awareness and fairness perceptions. This method helped in obtaining a balanced dataset that reflects different perspectives within the population. The collected data was analyzed using descriptive statistics to summarize responses and identify trends. A Chi-Square test was conducted to determine whether there is a significant relationship between (a) income level and tax fairness perception and (b) age and tax awareness.

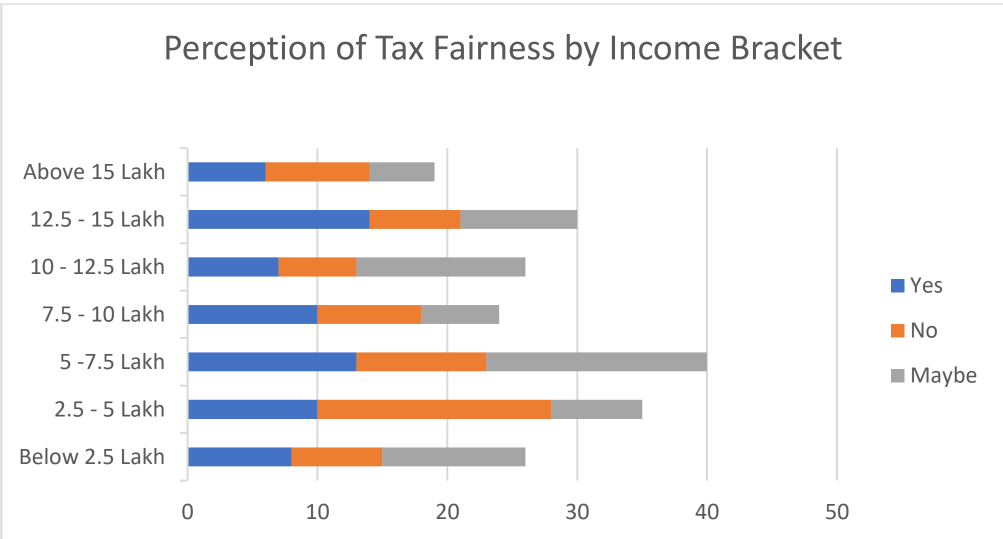
IV. DATA INTERPRETATION

Comparative Analysis

Scenario 1: How Income Affects Perception of Tax Fairness

Individuals perceive tax fairness differently depending on their income. Individuals who earn below ₹2.5 lakh perceive differently, and most of them are uncertain. More individuals in the ₹2.5-5 lakh bracket perceive the tax system to be unfair. With increases in income, perceptions are even but uncertainty still prevails even among individuals who earn more than ₹12.5 lakh.

If individuals earn more as the economy expands, individuals who shift to higher income groups may find the system fairer. But if the tax rates also rise, issues of equity may still prevail or even grow. The other alternative is to make changes in tax policies so that middle-class individuals contribute a smaller percentage of tax. That may make more individuals earning between ₹5-10 lakh think that the system is fair. Or individuals earning more than ₹15 lakh may also think that it is not fair if tax rates on them go up. These examples reveal that whether individuals find taxes fair or not depends on both the income group and how tax policies evolve over time.



Scenario 2: How Tax Awareness Varies by Age

One's understanding of taxes can vary with age. Young adults, particularly those aged 18 to 25 are the least knowledgeable about taxes. Most of them are not well informed about them. Individuals between 26 and 35 are better informed about taxes, while those between 46 and 55 know most about taxes, most likely because they have been dealing with taxes for many years.

If schools and colleges educate people about taxes then more youth would be aware of tax policy. And, with the use of technology and convenient filing, the 26-35 age group would move from partially aware to very well aware. Another proposal is that the government simplify the process of filing taxes. If filing taxes is simplified through the use of automated software, senior citizens, particularly above 46 years, would be more aware and active in the context of taxes.

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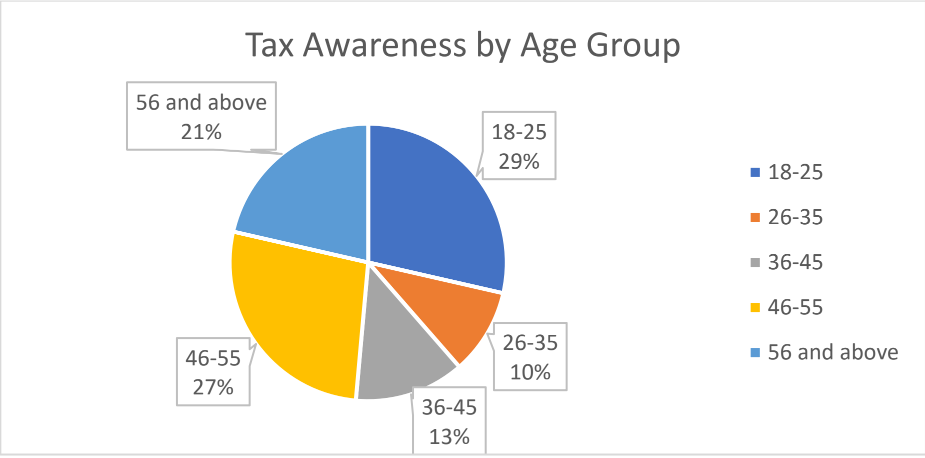

Chi-Square analysis

Chi-square analysis is a statistical method for determining whether there is a significant association between two categorical variables. It compares the observed frequencies of categories with the frequencies that would be expected if the variables were independent.

Formula:

CHI Square = $\sum \frac{(Observed-Expected)^2}{Expected}$

O = Observed frequency, **E** = Expected frequency, **O−E** = Difference between observed and expected values, **(O−E) ^2** = Square of the difference

Table 1
Income Level of Respondents and their Perception of Tax Fairness

Income Level	Perception of Tax Fairness by Income Bracket			
	Fair	Not Fair	Unsure	Grand Total
Below 2.5 Lakh	8	7	11	26
2.5 - 5 Lakh	10	18	7	35
5 -7.5 Lakh	13	10	17	40
7.5 - 10 Lakh	10	8	6	24
10 - 12.5 Lakh	7	6	13	26
12.5 - 15 Lakh	14	7	9	30
Above 15 Lakh	6	8	5	19
Grand Total	**68**	**64**	**68**	**200**

Hypothesis:

H0 – There is no significant association between the Income Level of Respondents and their Perception of Tax Fairness,
H1– There is a significant association between the Income Level of Respondents and their Perception of Tax Fairness

Calculated CHI–Square Value:

O	E	O - E	(O - E)^2
8	8.84	-0.84	0.71
10	11.9	-1.9	3.61
13	13.6	-0.6	0.36
10	8.16	1.84	3.39
7	8.84	-1.84	3.39

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14	10.2	3.8	14.44
6	6.46	-0.46	0.21
7	8.32	-1.32	1.74
18	11.2	6.8	46.24
10	12.8	-2.8	7.84
8	7.68	0.32	0.10
6	8.32	-2.32	5.38
7	9.6	-2.6	6.76
8	6.08	1.92	3.69
11	8.84	2.16	4.67
7	11.9	-4.9	24.01
17	13.6	3.4	11.56
6	8.16	-2.16	4.67
13	8.84	4.16	17.31
9	10.2	-1.2	1.44
5	6.46	-1.46	2.13
Total	**200**		**163.63**

Calculated CHI Square value = ∑ (O – E) ^2 / ∑E = 163.63/200
= 0.818

Chi-Square Table Value -
Degree of Freedom (DOF) = (R – 1) * (C – 1) = (7 – 1) * (3 – 1) = 6 * 2
= 12
Level of Significance = 5%, Table value of CHI Square = 21.026

Interpretation: -
The calculated CHI Square value 0.818 is lower than the table value 21.026 so it rejects the H1 Alternate Hypothesis and accepts the H0 Null Hypothesis. Hence there is no significant association between the Income level of respondents and their perception of tax fairness.

Table 2
The Age of the Respondent and their awareness of Tax and Tax rates

Age Group	**Tax Awareness by Age Group**			
	No not aware	**Somewhat aware**	**Yes, fully aware**	**Grand Total**
18-25	20	14	12	46
26-35	7	20	10	37
36-45	9	9	11	29
46-55	19	15	17	51
56 and above	15	12	10	37
Grand Total	**70**	**70**	**60**	**200**

Hypothesis:
H0 – There is no significant association between the Age of the Respondent and their awareness of Tax and Tax rates,
H1– There is a significant association between the Age of the Respondent and their awareness of Tax and Tax rates

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Calculated CHI–Square Value:

O	E	O - E	(O - E)^2
20	16.1	3.9	15.21
7	12.95	-5.95	35.4025
9	10.15	-1.15	1.3225
19	17.85	1.15	1.3225
15	12.95	2.05	4.2025
14	16.1	-2.1	4.41
20	12.95	7.05	49.7025
9	10.15	-1.15	1.3225
15	17.85	-2.85	8.1225
12	12.95	-0.95	0.9025
12	13.8	-1.8	3.24
10	11.1	-1.1	1.21
11	8.7	2.3	5.29
17	15.3	1.7	2.89
10	11.1	-1.1	1.21
Total	200		135.76

Calculated CHI Square value = ∑ (O – E) ^2 / ∑E = 135.76/200
= 0.678

CHI Square Table Value -

Degree of Freedom (DOF) = (R – 1) * (C – 1) = (5 – 1) * (3 – 1) = 4 * 3
= 12

Level of Significance = 5%, Table value of CHI Square = 21.026

Interpretation: -

- The calculated CHI Square value is 0.678 which is lower than the table value 21.026 so it rejects the H1 Alternate Hypothesis and accepts the H0 Null Hypothesis. Hence there is no significant relationship between the age of the respondent and their awareness of tax and tax rates

V. DISCUSSIONS

The research shows that direct taxes are highly effective in curbing economic inequality through redistributive impacts. Progressive taxation, where individuals who earn more are taxed a larger percentage, is more effective in bridging income gaps compared to flat taxation or indirect taxation systems. According to the data, nations with effective direct tax policies have lower income inequality. The study indicates that the efficiency of tax collection and enforcement significantly influences the number of individuals who comply with the tax laws. Nations with clear tax laws and effective enforcement tend to have more individuals paying their taxes, thus generating more revenue. Complicated tax systems and loopholes, however, tend to cause individuals to evade taxes and render direct taxation less efficient. The findings show that transparency in collection of taxes and expenditure makes individuals have faith in the system. When the taxpayers know where their money is going for public services, they will comply. However, when there is no transparency, individuals lose confidence and will try to evade taxes. Raising public awareness on tax policy and spending can increase the public's confidence in the system, and efficient communication of tax responsibilities and tax benefits can lead to better compliance. Applying information to impose taxes like electronic monitoring and computerized audits can encourage individuals to comply with the law and reduce tax evasion and making sure tax laws are applied equally can also result in a more equitable tax system. Realigning tax policies so that everyone pays the same amount can make taxes equal. Removing large deductions and exemptions for wealthy people and giving support to poor people can create a much fairer system.

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VI. CONCLUSION

This research proves just how crucial direct taxes are in mitigating economic inequalities by assisting in fairly redistributing wealth. By thoroughly analyzing tax legislation, how funds are raised, and their effects on society and the economy, it has been found that progressive taxation is one of the most significant ways of decreasing income inequalities. The research methodology used allowed careful attention to taxation systems and how well they work to bridge the gap of inequality. The conclusions are that fair taxation policies, enhanced compliance measures, and effective tax management help to deliver a more equitable economic system. In addition, the research shows that tax reforms must reduce loopholes, stop tax evasion, and ensure that more prosperous citizens pay a fairer percentage of national taxation. Governments need to focus on creating policies that ensure economic growth while assisting in creating social fairness for long-term prosperity. Future research may look at how direct taxes change in the digital age and how they affect the distribution of wealth in emerging economies.

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