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The Role of Taxation as a Redistributive Instrument in Reducing Economic Inequality and Promoting Inclusive Growth

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Abstract

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Economic inequality and income disparity represent complex phenomena closely linked to taxation policy and economic growth. High levels of income inequality can hinder economic expansion by reducing social stability and weakening investment incentives, while non-inclusive economic growth further deepens income disparities. Taxation functions as a fundamental instrument for wealth redistribution and macroeconomic stabilization; however, its effectiveness depends on taxpayer compliance, fiscal transparency, and the perceived fairness of the tax system. This study employs a library research approach by analyzing various empirical studies concerning the relationship between taxation and economic inequality. The findings indicate that a progressive tax system can effectively reduce income inequality, yet poorly designed tax policies may exacerbate socio-economic disparities. Therefore, tax reforms oriented toward equity and inclusive development are essential to achieving sustainable and balanced economic growth. Strengthening fiscal institutions, promoting accountability, and ensuring justice in tax administration are pivotal to realizing taxation's role as a driver of social welfare and long-term development.

1. Introduction

Economic inequality and uneven income distribution have become global issues with broad implications for the social, political, and economic stability of a country. Within the framework of classical economic theory, economic growth is believed to reduce inequality through the trickle-down effect mechanism, where increased prosperity among the upper-income groups is expected to cascade down to lower societal layers. However, various empirical evidence shows mixed results; in many cases, high economic growth is not always accompanied by equitable welfare distribution. High-income inequality often creates social instability, reduces public trust in the government, and hinders investment flow and economic growth performance (Eydam & Qualo, 2024).

Taxation is a fundamental instrument in fiscal policy that plays a strategic role, not only as the primary source of state revenue but also as a means for wealth redistribution and macroeconomic stabilization. Through a progressive and fair tax system design, the government can suppress the income gap between social groups. Progressive taxation allows for a greater tax burden on high-income groups, so that fiscal resources can be reallocated to support low-income groups (Dianov et al., 2022). However, the effectiveness of taxation as an equalization tool is often hampered by various factors such as tax avoidance practices, weak fiscal oversight systems, corruption, and low levels of taxpayer compliance. These conditions result in suboptimal potential state revenue and make the goal of economic redistribution difficult to achieve.

The relationship between tax policy and economic inequality is dynamic and complex. A number of studies find that tax policies that tend to favor high-income groups actually worsen income inequality. Conversely, a tax structure that sides more with middle and lower-income communities can strengthen purchasing power, increase domestic consumption, and encourage more inclusive economic growth (Karakotsios et al., 2020). Thus, the orientation of taxation policy needs to consider not only the aspect of fiscal revenue but also its overall impact on social welfare. The structure of taxation plays a critical role in the process of national wealth distribution. When individual income tax is imposed higher than taxes on wealth or capital, the economic gap can increase because capital owners gain greater profits without proportional fiscal contribution. Conversely, the implementation of taxes on wealth, inheritance, or capital gains can be an effective instrument to encourage fairer economic redistribution.

Therefore, tax structure reform needs to be directed towards a balance between economic efficiency and social justice. In the context of globalization and digital economic transformation, new challenges emerge that further complicate the dynamics of global taxation. Multinational corporations now have the ability to shift profits across jurisdictions through international tax avoidance schemes, which in turn reduces the domestic tax base. This phenomenon widens the fiscal gap between developed and developing countries and hinders global income redistribution efforts. Therefore, international tax reform, including the implementation of a global minimum tax policy, is a crucial step in strengthening cross-border fiscal fairness.

This study aims to analyze the reciprocal relationship between economic inequality and tax policy through a review of the latest literature. This approach is intended to identify the strategic role of taxation in balancing economic growth and equitable income distribution. Furthermore, this research emphasizes the importance of fiscal transparency, increased taxpayer compliance, and the strengthening of redistributive policies that are adaptive to the changing structure of the modern economy. Thus, taxation is viewed not only as an instrument of state revenue but also as a key pillar in creating economic justice and long-term social sustainability.

2. Literature Review

2.1. Taxation and Economic Inequality: Theoretical Perspectives

Taxation has long been recognized as a fundamental instrument in regulating income distribution and achieving economic equilibrium. According to Tjan (2024), a progressive tax system has a strategic role in suppressing social inequality through income redistribution mechanisms, namely by rechanneling a portion of the wealth from high-income groups to low-income communities through public expenditure policies. This concept aligns with the fiscal redistribution theory which asserts the importance of tax intervention to offset the inequality arising from uneven wealth accumulation within the economy. Furthermore, Nurwanah (2024) emphasizes that the effectiveness of tax policy in reducing inequality highly depends on the national economic structure and the accompanying social policies.

Countries with a broad tax base and a more progressive system tend to show lower levels of income inequality compared to countries that rely on indirect taxes, such as consumption tax. This indicates that the design of the tax system not only determines the amount of state revenue but also affects economic justice and social equity. In the view of both classical and contemporary literature, the relationship between taxation and inequality is reciprocal. When the tax system is unable to adapt to changing economic dynamics, the effectiveness of redistribution weakens. Cahyadi (2024) asserts that the link between tax policy and public infrastructure development is a key element in creating economic equity, because infrastructure financed by taxes can expand economic access more inclusively. Thus, taxation acts not only as a fiscal instrument but also as a catalyst for sustainable social development.

2.2. Dynamics of the Relationship between Taxation and Income Distribution

Various empirical studies show a significant relationship between taxation policy and the level of income inequality in a country. Agussalim et al. (2024) found that fiscal policy, especially direct taxation, makes a real contribution to poverty and inequality reduction through a multiplier effect on economic growth and increased employment opportunities. This finding indicates that an appropriate tax policy design can create a multiplier effect for inclusive economic development. Furthermore, research conducted by Dianov et al. (2022) shows that disproportionate tax systems in the European Union area actually exacerbate inequality, especially when the proportion of indirect tax is greater than income tax.

Such a regressive tax structure tends to place a greater burden on low-income communities, thereby widening the gap in social and economic inequality.

Another study by Musibau et al. (2024) used the Bayesian Model Averaging approach to analyze the relationship between fiscal policy and inequality across various countries. The results of the analysis indicate that increasing direct tax rates for high-income groups has the potential to significantly reduce inequality without impeding the rate of economic growth. This finding is consistent with the study by Karakotsios et al. (2020), which identified a long-term relationship between economic freedom, tax structure, and income inequality in the European region. Moreover, Eydam and Qualo (2024) assert that countries with progressive tax systems tend to have greater social stability and more sustainable economic growth compared to countries with regressive tax systems. Thus, taxation functions not only as a fiscal instrument but also as an important pillar in determining the direction of just socio-economic development.

2.3. Reform Directions and Global Challenges

The era of globalization and digitalization presents new challenges in the global tax system. Tjan (2024) emphasizes the importance of adapting tax policies to the digital economy, given that multinational companies often exploit legal loopholes to avoid tax. This results in reduced state revenue and increased inequality between sectors. Digital tax reform, such as the global minimum tax, is important to ensure that large entities contribute fairly to development.

In addition, Supriadi (2023) asserts that the success of progressive taxation in reducing inequality depends on the consistency of policy implementation and the effectiveness of fiscal institutions in enforcing the rules. If tax policy is applied fairly and transparently, public compliance will increase, and public trust in the government will rise.

Agussalim et al. (2024) also added that inclusive fiscal policies can strengthen the inequality reduction effect through the financing of the education, health, and productive infrastructure sectors. Targeted fiscal intervention is proven to increase human capital and expand economic opportunities for low-income groups. The literature of the last five years shows a consensus that taxation plays a crucial role in suppressing inequality, but its success is highly influenced by policy design, institutional capacity, and public transparency. Tax reform oriented towards social justice is an urgent need to address the challenges of economic inequality in the global era.

3. Method

This study uses a library research approach to analyze the relationship between economic inequality, income distribution, and the role of taxation in suppressing socio-economic gaps. This approach was chosen because it allows the researcher to comprehensively review theories, empirical findings, and current fiscal policy trends from various relevant scientific sources over the last five years. According to Tjan (2024), the library research method is an effective approach in assessing the impact of the tax system on inequality by systematically integrating various prior research findings. The literature sources used in this study include academic journals, scientific articles and indexed in scientific databases such as Google Scholar or Research Gate.

The research stages begin with the identification of the topic and the formulation of the problem focusing on the role of taxation in reducing economic inequality. After that, secondary data is collected in the form of scientific literature published in the last five years, followed by content analysis of the arguments, methodology, and relevant research results. Furthermore, thematic synthesis is conducted to obtain conceptual conclusions that are comprehensive and oriented towards the relationship between tax policy and income equity. Data analysis is carried out using a qualitative descriptive approach, with the aim of identifying patterns, relationships, and connections between economic variables such as growth, income, and fiscal policy. This approach is considered relevant because the main focus of the research is not on testing quantitative hypotheses, but on the conceptual understanding of socio-economic dynamics. Each article used is evaluated based on its level of relevance to the topic, the novelty of the findings, and its methodological validity.

The literature selection refers to specific inclusion criteria: scientific publications published in the last five years, focused on the relationship between taxation, inequality, and redistribution policy, and containing empirical evidence or theoretical models related to fiscal policy. As a form of validation, findings from various sources are compared across countries and economic contexts to identify variations in the pattern of tax influence on inequality. This analysis method adopts the Systematic Literature Review (SLR) framework as applied by Dianov et al.

(2022), which emphasizes the importance of critical evaluation of the literature based on reliability and consistency of research results. Thus, this study is expected to provide a comprehensive understanding of the effectiveness of taxation in addressing income inequality, as well as offering a theoretical basis for fairer, more adaptive, and sustainable fiscal policy reform.

4. Results

The results of this study show a strong reciprocal relationship between economic inequality and taxation policy. Taxation not only functions as a source of state revenue but is also a major instrument in income redistribution and socio-economic stabilization. Analysis of various literature over the last five years confirms that the effectiveness of taxation policy in suppressing inequality is highly influenced by the design of the tax system, the capacity of fiscal institutions, and the level of transparency and compliance of the public with tax obligations. In this context, progressive taxation and good fiscal governance are the main pillars for achieving income equity and long-term economic sustainability.

The research conducted by Mdingi (2021) shows that the implementation of a progressive tax system is one of the most effective mechanisms for reducing the income gap. Through this scheme, wealth concentrated in high-income groups can be rechanneled to low-income communities through productive public spending. This finding is consistent with the theory of fiscal redistribution which affirms that tax policy has a strategic role in creating economic equilibrium by correcting market distortions due to wealth accumulation in the hands of a few individuals.

Nevertheless, the effectiveness of progressive taxation highly depends on the government's ability to minimize fiscal leakage and overcome tax avoidance practices generally carried out by large corporations. Without transparent governance and strong oversight, the redistributive potential of progressive taxation will be difficult to realize optimally.

The study by Musibau et al. (2024) strengthens this finding by using the Bayesian Model Averaging approach to assess the contribution of taxation to inequality reduction in developed and developing countries. The analysis results show that countries with strong direct tax systems such as individual income tax and corporate tax tend to have lower levels of income inequality compared to countries that rely more on indirect taxes such as Value Added Tax (VAT) and excise duty. However, indirect taxes still play an important role in expanding the state's revenue base, especially when balanced with social compensation policies for low-income groups. Policies such as basic necessity subsidies, conditional cash transfers, and social incentives are proven to reduce the burden of regressive taxes experienced by the poor.

In line with these findings, Agussalim et al. (2024) affirm that inclusive fiscal policy is capable of suppressing poverty and inequality through increased public investment in the education, health, and productive infrastructure sectors. Government spending sourced from progressive tax revenue creates a multiplier effect on economic growth and the equalization of job opportunities. The improved quality of human resources through this social investment not only strengthens national economic competitiveness but also expands social mobility between layers of society. Thus, progressive taxation acts not only as a fiscal tool but also as a catalyst for sustainable human development.

However, the effectiveness of tax policy in addressing inequality is also highly dependent on the structure and complexity of the tax system. Ganghof (2024) found that in a number of European countries, the dominance of indirect taxes resulted in a heavier fiscal burden for low-income groups, thus reducing the expected redistribution effect. This condition indicates that the balance between direct and indirect taxes is an important aspect of creating fiscal justice. Tax reform needs to be directed towards structuring tariffs and the tax base so that the contribution of each social group is commensurate with their economic capacity. When the tax system relies too heavily on consumption levies, the impact is actually counterproductive to the goal of social equity.

Apart from structural factors, the results of this study also reveal that public perception of the fairness and transparency of the tax system significantly influences the level of taxpayer compliance. When the public believes that taxes are used efficiently, transparently, and provide tangible benefits for public welfare, compliance levels tend to increase. Conversely, low trust in fiscal governance can trigger tax avoidance practices and exacerbate social inequality. Nurwanah (2024) emphasizes the importance of the moral and social justice dimensions in the tax system which need to be strengthened through inclusive and participatory fiscal communication policies. Increased tax literacy, openness of budgetary information, and public involvement in fiscal planning are important factors in building the legitimacy of the national tax system.

Another relevant finding is the close relationship between taxation policy and inclusive economic growth. High economic inequality is proven to hinder long-term growth because it reduces community purchasing power and decreases labor market efficiency. Conversely, tax policies that support wealth redistribution through social programs, education subsidies, and support for Micro, Small, And Medium enterprises (MSMEs) are able to expand the economic base and encourage national productivity. These research results are consistent with the findings of Eydam and Qualo (2024), which show that countries with high tax redistribution rates have more stable economic growth compared to countries with regressive tax systems. Thus, the role of taxation is not only related to macroeconomic stability but also to strengthening the socio-economic foundation of society as a whole.

Furthermore, this research identifies new challenges arising from changes in the global economic structure, particularly those influenced by digitalization and financial globalization. Many multinational companies now exploit international regulatory loopholes to shift profits to jurisdictions with low tax rates (Butarbutar, 2022). This practice of profit shifting reduces the domestic tax revenue base and exacerbates the economic gap between countries. Therefore, the implementation of a global minimum tax is a strategic step in creating a fairer and more sustainable international tax system. Collaborative efforts between countries through forums such as the Organisation for Economic Co-operation and Development (OECD) and G20 are important to ensure that the profits from global economic activity are distributed proportionally and do not only benefit large corporations.

In addition to the global aspect, strengthening institutional capacity within the domestic tax system is also a key factor in increasing the effectiveness of fiscal policy. Countries with efficient tax administration, high transparency, and good digital infrastructure tend to be more capable of minimizing fiscal leakage and increasing the efficiency of tax collection (Roger, 2021). Innovations such as e-filing systems, the digitalization of taxpayer data, and the integration of information with financial institutions are proven to strengthen fiscal compliance while reducing the space for tax avoidance practices. This institutional capacity strengthening not only increases state revenue but also reinforces government credibility in managing public funds accountably.

From a social perspective, prolonged economic inequality can lead to political instability and reduce social cohesion within society. In this context, taxation acts as an instrument to strengthen government legitimacy through a broader distribution of economic benefits. When the public feels the real results of their tax contributions in the form of quality public services, the sense of social justice and fiscal solidarity will increase. Thus, effective fiscal policy is not only oriented towards increasing state revenue but also functions as a mechanism for strengthening social trust between the state and its citizens (Sofyani et al., 2022). In addition to the empirical results obtained, this study also highlights the importance of synergy between fiscal policy and social policy in tackling economic inequality. Inequality cannot be resolved through tax instruments alone but requires support from inclusive education, social protection, and workforce development policies.

The integration between fiscal redistribution policy and human development programs is a prerequisite for creating sustainable and equitable economic growth. By strengthening cross-sectoral coordination, taxation can function optimally as a driving force for inclusive growth and a means to uphold the principles of distributive justice in national development. The results of this study confirm that a progressive and transparent tax system is proven effective in suppressing income inequality and strengthening long-term economic stability. Tax compliance and public trust are crucial elements in ensuring the effectiveness of redistribution policy, while global tax reform is needed to face the challenges of the digital economy and cross-border tax avoidance practices. Therefore, taxation should be viewed not merely as a fiscal instrument, but as the foundation of social and economic justice. In the context of sustainable development, tax policy needs to continue to be directed towards increasing equity, transparency, and efficiency, with a primary focus on the welfare of society as a whole.

5. Discussion

The results of the literature review indicate that taxation has a strategic function in creating economic equilibrium while strengthening social stability. Taxation plays a role not only as an instrument for collecting state revenue but also as a primary means of wealth redistribution to achieve social justice. Nevertheless, the effectiveness of the tax role is highly determined by policy design, the quality of fiscal governance, and public perception of the fairness of the tax system. According to Mdingi (2021), the implementation of a progressive tax system is proven capable of suppressing income inequality if accompanied by transparency in the use of public funds and strict oversight of tax avoidance practices. This view aligns with redistributive economic theory, which emphasizes the state's responsibility in rechanneling societal wealth through fiscal instruments to maintain social welfare and correct economic imbalances originating from market mechanisms.

High economic inequality often becomes a hindering factor for social stability and long-term growth. In this context, taxation functions not only as a source of development funding but also as an equalization instrument capable of enhancing economic inclusivity. Purwanti (2024) assert that the effectiveness of taxation policy will be higher if it is integrated with human development policies, especially through investment in the education, health, and social infrastructure sectors. This synergy creates a more sustainable redistribution effect because it improves the quality of human resources while expanding access to economic opportunities. Taxation focused solely on increasing revenue without considering the distribution of its benefits actually has the potential to deepen social gaps. Therefore, fiscal policy oriented towards equity must balance economic efficiency and social justice as the foundation for national development sustainability.

In addition to structural factors and economic policy, the dimension of public trust in the government also plays a crucial role in determining the effectiveness of the tax system. Nurwanah (2024) shows that low fiscal transparency and the perception of injustice in the tax collection process can reduce the level of taxpayer compliance and widen the space for avoidance practices. In this context, accountability and public information openness are important elements in strengthening the state's fiscal legitimacy. Reform of the tax system through digitalization, administrative simplification, and increased public access to fiscal data can build a more constructive relationship between the state and its citizens. These efforts in turn increase social participation and strengthen the sense of fairness within the national taxation mechanism. From a global perspective, the modern tax system faces significant challenges due to accelerated globalization and economic digitalization. Musibau et al. (2024) suggest that changes in the structure of cross-border economic activity demand stronger international tax policy coordination to suppress tax avoidance practices by multinational companies.

Without global reform, developing countries will continue to face tax revenue gaps and fiscal limitations that hinder the implementation of effective redistribution programs. Therefore, the formation of a fair global tax framework, including the international minimum tax initiative, is a strategic step in realizing a more balanced fiscal system in the digital economic era. Overall, this study confirms that taxation acts as the main instrument in balancing the dynamics between economic growth and social equity. However, its success demands comprehensive integration between fiscal policy, transparent public governance, and inclusive social participation. Tax reform oriented towards social justice, administrative efficiency, and the digitalization of the fiscal system is the strategic direction for sustainable, equitable, and adaptive economic development in the face of global challenges.

6. Conclusion

Economic inequality and income represent major challenges in sustainable development that require effective fiscal intervention. Based on a review of the literature over the last five years, taxation is proven to have a strategic role in suppressing inequality through income redistribution mechanisms and the financing of social development. A progressive tax system, if implemented with high transparency and accountability, can strengthen economic stability, increase public trust, and accelerate the equalization of welfare. However, the effectiveness of taxation is highly dependent on institutional factors and other supporting policies. When the tax system faces administrative complexity, low compliance, and tax avoidance practices, the goal of redistribution becomes difficult to achieve. Therefore, tax reform must be directed towards system simplification, increased digitalization, and the strengthening of fiscal institutional capacity.

In addition, international cooperation in imposing global taxes and controlling cross-border tax avoidance is essential in the digital economic era. The integration between fiscal, social, and human development policies will make taxation not merely a source of revenue, but also an instrument of social justice. This study affirms that taxation is the primary foundation for realizing economic growth that is inclusive, just, and sustainable. The government needs to maintain a balance between economic efficiency and social equity so that the tax system truly functions as a driver of shared prosperity.

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