CHAPTER I

INTRODUCTION

The concept of the 'state' underwent several transformation with definitions, dimensions and functions added to it with the passage of time. Entrusted with additional functions and responsibilities to discharge, it became imperative to create a sound state not only politically but also financially and therefore, newer sources of revenue were contemplated.

Earlier days, the office of the ruler was regarded as a private property. His revenue came from his estates and certain other prerogatives and there was no system of taxation in the modern sense. Taxes did not exist in the Hebrew tribal economy. In the reign of King Solomon, 'Corvee' or labour service was exacted from labouring class for undertaking roads, bridges and other public works. The tax called a 'tribute' was realised from only men for maintaining the places of worship (Haney, 1979).

In India, known as 'bali' meaning 'offering' in pre-vedic period and later 'rajkar', taxation was regarded as one of the most important sources of revenue. Our political and economic literature is replete with such exhortations made to ancient kings.
Taxation was ostensibly for the maintenance of the government. The subjects of the state were taxed according to the benefits they received from the state and therefore, taxes were willingly paid. Whatever was the system of administration, the policy of taxation remained unchanged. The rate of tax was determined by the public authority according to the dictates of the Hindu religion and the king was accountable only to himself and to God (Mahabharath, Chapter 71, Sloga 10, in Hajela, 1994).

An ancient masterpiece on economic ideas available now is Kautilya's Arthashastra. It dates back to fourth century B.C. The author was the chief minister of Chandragupta Maurya who ruled the great Indian empire during the time. Arthashastra is said to be one of the best pieces of literature on politics and economics and it lays down principles of public administration and public finance. According to Kautilya, taxes were levied cautiously not to prove a heavy burden on the tax payers. The tax system should be such as not to prove a great burden on the public, the king should act like a honey bee which collects honey without inconveniencing the plant. Kautilya further laid two principles to mobilise taxes. He said that a tax should be levied once a year and should not prove burdensome. It should be levied according to the ability of pay. Wealthy persons who had to contribute more towards the expenses of
the state were respected and given a prominent place in the society. In so far as the sources of revenues were concerned, they included taxes on land, forests, property, etc., of which a tax on land was dominant (Hajela, 1994).

During mercantilists days the land was heavily taxed and the land owned by noble and clergy was exempted. The land tax was known as 'taille' and other taxes were 'gabelle' (salt-tax), 'aides' (tax on commodities) and 'traite'(customs duties). However, mercantilists preferred wealth by trade to wealth by taxes; because some kind of taxes and public levies may rather diminish than increase the wealth of the king (Spiegel, 1971).

The physiocrats inextricably bound up the theory of taxation with the theory of net product. The net product was the only source to be tapped for taxes. They suggested a single tax on land. The physiocrats argued that taxes should be paid by the people liberally. They were required for meeting expenses of the state for the maintenance of internal security, spread of education, establishment, public works and for increasing the productivity of land. They did not favour indirect taxes and tax on commodities (Gide and Rist, 1973).

Adam Smith (1776) in his fifth book of Wealth of
Nations deals with the revenue of the sovereign or commonwealth. To him public finance is needed for meeting out the responsibilities of the state. He pointed out two sources of public revenue - (i) land and capital of the state and (ii) taxes. In order to guide the revenue authorities, he laid down the four popular canons of ability, certainty, convenience and economy which prescribed the broader perspectives in which the theories of taxation should operate.

With the emergence of ever transforming political and economic systems, tax revenues constituted the primary and major source of revenue to the government. The tax system showed diverse structure in different countries, depending on their political set up and the level of economic advancement. A look back at the history of taxation maintains that all the earlier taxes were only direct taxes and they were paid as a quid pro quo for the benefits they received from the king. Indirect taxes in those days were either unknown or unpopular, across the countries. However, with the dilution of ethical values both among the rulers and the ruled, the tax system underwent modifications. Of the direct and indirect taxes, the tax administrators preferred the former since their collection was certain, convenient and relatively economic; while the tax payers preferred the latter, for they provided an opportunity for
shifting the burden to the weaker among themselves. This became a reality in England, in translating the theories into practice. The English kings did not favour direct taxation since it required an efficient bureaucracy and more searching method of ascertaining an individual's income and wealth. It was rather much easier to raise money by customs and excise in England in those days. However, they needed "shield money" for war financing and thus resorted to both the sources of direct and indirect taxation. After feverishly trying window tax, and taxes on silver plates, female servants, pleasure horses, pet dogs, watches and clocks, they finally set the tax arrow targeting on income. It was William Pitt who imposed a tax on income in 1799 and it did not exceed 10 per cent of the total income in his time. He introduced graduated income tax, but it was felt wiser to get rid of such graduation and simplify it as much as possible. The Pitt's income tax was branded as a 'war tax', and therefore, people wanted it to be repealed immediately after war (Sabine, 1966).

In India, as V.K.R.V. Rao (1931) observes, like the introduction of the study of the English language in the Indian education, the introduction of the income tax in the Indian financial system is one of the few happy heritages of British rule in the country. After 1833, the financial
system was highly centralised, with the central government controlling all details of provincial expenditure. This period witnessed the demise of East India Company and the subsequent direct administration by the British crown. All revenues accrued to the centre, with the provinces getting fixed payments for their expenses. Revenue elasticity was absent, since local tax bases were not tapped (Venu, 1978). Nevertheless, British representatives in India were afraid to introduce income tax as one of the viceroys observed: "Danger for danger, I would rather risk governing India with an army of only 40,000 Europeans than I would risk having to impose the unpopular tax on income" (Dharma Kumar, 1982).

Personal income tax was levied in India for the first time in 1860 by John Wilson to end the budget deficits which followed the uprising of 1857. A number of experiments were made during the period from 1860 to 1886 in the field of taxation of income. The first systematic legislation on income tax was enacted only in 1886. The Act underwent many amendments to cope up with the requirements of time. The Government of India Act 1919 made income tax a central subject, following which the Income Tax Act 1922 was passed. It remained in force for forty years. It was replaced by the Income Tax Act of 1961, the most comprehensive piece of legislation having 198 sections and 4 schedules. The new
Act applied to whole of India including the state of Jammu and Kashmir and came into force on 1st April 1962.

The present Act has also been subjected to several amendments to accommodate the commitments of the successive democratic governments and also to incorporate the recommendations made by various taxation enquiry commissions from time to time.

The primary objective of personal income tax, like any other tax, was to mobilise additional resources to the exchequer. But with the passage of time and with the changing political and economic scenario, the spirit of personal income taxation has been strengthened with additional objectives of equity, income redistribution and social justice. In this context, it is pertinent to record the issues related to the above objectives of personal income taxation in India.

Firstly, in respect of mobilisation of revenue, personal income tax revenue in India registered an increase in terms of personal income tax payers, income assessed and personal income tax payable over the years. In this regard, elasticity and buoyancy of tax are effective in evaluating the mobilisation of such tax revenue. Hence, one of the issue is to what extent personal income tax collection responds to increase in gross domestic product and how far
changes in personal income taxation policy of the government in terms of tax base, tax rate and concessions influence the resource mobilisation.

Secondly, the objective of personal income taxation as an instrument of equity, social justice and income distribution, was considered. By adopting progressive taxation policy the government is able to attain this objective. In this context, Thimmaiah (1986) asserted that there has been a close relation between the fiscal policies and social justice, while using such policies for economic development in developing economies like India. This objective may be assessed on the basis of burden of tax payers and its impact on income distribution. Hence, the second issue of the study is what the level of burden borne by the personal income tax payers was and how it was progressive over the years in India and also how far the personal income taxation is able to attain the equality of distribution of income and wealth and if it is so, what its determinants are.

Thirdly, personal income taxation is generally influenced by socio-economic and political factors, such as gross domestic product, density of population, urban population, population of scheduled caste and scheduled tribe, literacy rate, primary sectoral contribution, public
debt, public expenditure, price index and change of party in power. Identification of determinant factors of personal income taxation are immensely useful from the policy point of view to augment resources of the government. Hence, another issue of the present study is what the different socio-economic determinants are and to what extent they influence the mobilisation of personal income taxation in India over the years.

Fourthly, the role of political factors affecting the fiscal outcomes has received increasing attention in recent years (Downs, 1957; Buchanan and Tullock, 1962; Niskanen, 1971 and Breton 1974). In this context, Palkhiwala (1965) advocated that bad economics might temporarily be good politics, but politics should be behind a fiscal law and not in front of it. In India, the political scenario has changed from stability to instability after 1975. Until then, congress party had the monopoly power base both in the centre and in most of the states of the Indian union, which was conducive for consistent policy on the basis of economic principle. But the emergency clamped in by Mrs. Indira Gandhi in 1975 resulted in drastic change in government policy and political exigencies that followed it. Sequel to emergency excesses, Congress was unseated from power both at the centre and in most of the states and it was replaced by
opposition parties. It was after this period, the emphasis of government policy changed from economic measures to more and more populist measures such as free rice, free meals to children, minimum needs programme, rural development schemes, loan mela and so on, keeping in mind the prospective vote bank and the next election. Successive governments, Congress or non-Congress, competitively resorted to these pro-people populist economic policies. The seed for all these political developments linking economic policies was sown by the emergency of 1975. Besides, successive governments adopted the policy of raising exemption limit and reduction in tax rates of personal income taxation in India. In this context, it is worth mentioning the opinion of Thavaraj (1992) that it is impossible to insulate policy making and tax administration from the vagaries and exigencies of political climate in the government. Further, Chug and Uppal (1986) narrated that the emergency clamped on the country in 1975 made breaking law. Tax evasion was deterently punished and this was responsible for the dramatic increase in the tax collection during the year. It was substantiated by the decline in the tax revenue right after emergency with disappearance of fear of punishment, though the tax rates continued to go down. In the above context, the other issue of our study is how far change of political stability into instability
influences the determinants of impact of personal income taxation on income distribution and the determinants of personal income taxation in India.

Objectives

Keeping the above issues in mind, the present study of personal income taxation in India, attempts to investigate the following objectives:

1. To sketch the earlier literature pertaining to the personal income taxation and to identify the gaps of the study,

2. To trace the trend and pattern of personal income taxation in India,

3. To estimate the elasticity and buoyancy of personal income taxation in different income ranges and to find an explanation for the differences in such elasticity and buoyancy,

4. To examine the burden, progressivity of personal income taxation and its impact on income distribution in India,

5. To find the determinants of impact of personal income taxation on income distribution and to verify the
influence of structural disturbances on the determinants of impact of personal income taxation, and

6. To identify the socio-economic, demographic and political determinants of personal income taxation in India and to verify the stability of such determinants of personal income taxation.

Methodology

Simple ratios and percentages were employed to examine the trend and pattern of personal income taxation. Further, the linear growth rate is computed to identify the growth of personal income tax payers, income assessed and the tax payable and it is presented in the following form:

\[ Y_i = A + BT + u \]

\[ i = 1,2,3 \]

Where,

\[ Y_1 = \text{number of tax payers}, \]

\[ Y_2 = \text{income assessed}, \]

\[ Y_3 = \text{personal income tax payable}, \]

\[ T = \text{trend and} \]

\[ u = \text{random error term}. \]
Thus, the linear growth rate is computed as
\[ = \left( B \cdot \frac{1}{Y} \right) 100. \]

We employed 'z' test statistic to test the null hypothesis such that there is no significant difference against the alternative hypothesis that there is a significant difference in the growth rates, (number of tax payers, income assessed and amount of tax payable), when we move from political stability to instability. The computed 'z' statistic is presented below:

\[ z = \left( G_1 - G_2 \right) / \left( \frac{d_1^2}{n_1} + \frac{d_2^2}{n_2} \right)^{1/2} \]

... \( n_1 + n_2 - 2 \) d. f.

Where,

\[ G_1 = \text{growth rate during 1962-1975}, \]
\[ G_2 = \text{growth rate during 1975-1989}, \]
\[ d_1^2 = \text{variance during 1962-1975}, \]
\[ d_2^2 = \text{variance during 1975-1989}, \]
\[ n_1 \& n_2 = \text{sample size during the two phases}. \]
Since different tax rates were applicable to different income ranges and also the super tax was payable beyond a level of income under the 'slab' system of taxation, the tax payers were grouped according to the income ranges. They were classified into as many as 19 groups in 1962-63 and only into 9 groups in 1988-89. For the purpose of clarity, simplicity and comparability of data, the present study groups the tax payers into four categories based on their income ranges; viz., those with income of Rs. 20,000 and below, those with income from Rs. 20,000 to Rs. 50,000, those with income of Rs. 50,000 to Rs. 1,00,000 and with income above Rs. 1,00,000.

Consumer price index of 1981-82 is used to adjust the nominal values of income assessed and the tax payable. In addition, the time span is divided into two phases (1962-1975 and 1975-1989) to identify the influence of change of political stability to instability on personal income tax collections.

Divisia index method is employed to estimate the buoyancy and elasticity of personal income taxation. Under Divisia Index method, the trend in tax ratio (tax revenue divided by gross domestic product) can be explained by writing aggregate personal income tax revenue (T) as a
homogenous function of gross domestic product \((X)\) and it is presented below:

\[ T = AX^u \quad \cdots \cdots \cdots \quad (1) \]

with \(X\) rising through time, the tax ratio \((T/X)\) remains constant of rises through time as the value of 'u' equals or exceeds unity.

The Divisia Index of discretionary revenue growth adjusts the estimated buoyancy of personal income tax revenue in order to obtain the elasticity. The estimates of buoyancy of personal income tax are made from unadjusted historical revenue data for the time interval \((o, n)\) by estimating the tax function and elasticity of income tax are obtained by adjusting the buoyancy as:

\[ r = u - \frac{\log D(n)}{\log X(n)/X(o)} \quad \cdots \cdots \cdots \quad (2) \]

Where,

\[r\] = elasticity estimate of the tax,
\[u\] = buoyancy of tax yield,
\[D(n)\] = index of discretionary tax revenue growth,
\[X(n)\] = gross domestic product of the current period,
and
\[X(o)\] = gross domestic product of the initial period.
Average and marginal burdens of personal income tax are computed to examine the burden of personal income taxation and it is presented below:

Average Burden of Personal income tax  \( = \frac{T}{Y} \)
Marginal burden of personal income tax  \( = \frac{\Delta T}{\Delta Y} \)

Where,

\( T \) = Personal income tax,
\( Y \) = Income of the tax payers, and
\( \Delta \) = Change.

Tax level and tax progressivity are considered to identify the progression of personal income taxation. Tax level can be represented by a weighted average of statutory marginal tax rate and it is computed as follows:

\[
TL = \sum_{i=1}^{k} w_i m_i
\]

Where,

\( TL \) = Tax level,
\( m \) = Marginal tax rate \( \Delta T/\Delta Y \)
\( w \) = Weight attached to the respective marginal tax rate i.e., proportion of tax payers to total tax payers in each income range.
Tax progressivity is computed by using Kakwani's measure of tax progressivity and it is defined as:

\[ TP = \frac{(1-t)}{t} (G_1 - G_2) \]

Where,

\[ TP = \text{Tax progressivity}, \]
\[ t = \text{average tax rate (T/Y)}, \]
\[ G_1 = \text{Gini co-efficient of income distribution before tax and} \]
\[ G_2 = \text{Gini co-efficient of income distribution after tax.} \]

Gini coefficient ratios of pre-tax and post-tax income distribution are computed for examining the redistributive impact of personal income taxation on income distribution and it is presented below:

\[
\frac{\sum_{i=1}^{n-1} X_i Y_i + 1 - \sum_{i=1}^{n-1} Y_i X_i + 1}{10,000}
\]

Gini coefficient ratio = \[
\frac{\sum_{i=1}^{n-1} X_i Y_i + 1 - \sum_{i=1}^{n-1} Y_i X_i + 1}{10,000}
\]

Where,

\[ X_i = \text{cumulative percentage of number of tax payers and} \]
\[ Y_i = \text{cumulative percentage of income.} \]

For identifying the determinants of redistribution impact of personal income tax on income distribution, the
following loglinear multiple regression equation is employed (Pawan K. Aggarwal, 1990a).

\[ LRI = a_0 + a_1 LTP + a_2 LTL + a_3 LIE + u \]

Where,

RI = Redistributive impact of personal income tax on income distribution i.e., the difference between the Gini co-efficients of pre-tax and post tax income distribution,

TP = Tax progressivity,

TL = Tax level,

IE = Inequality of pre-tax income distribution,

u = Random error term,

L = residual Logarithm, and

\( a_1, a_2 \text{ & } a_3 \) = parameters to be estimated and we expect the sign of that parameter is positive.

The multiple linear regression model was adopted to identify the determinants of personal income taxation and it is presented below:

\[ Y = b_0 + b_1 PGDP + b_2 DP + b_3 LR + b_4 UP + b_5 SCST + b_6 PPE + b_7 PPD + b_8 PSC + b_9 CPI + b_{10} DV + u \]

Where,

Y = per capita personal income tax,
PGDP = per capita Gross Domestic Product,
DP = density of population,
LR = literacy rate,
UP = percentage of urban population,
SCST = percentage of Scheduled Caste and Scheduled Tribe population in total population,
PPE = per capita public expenditure,
PPD = per capita public debt,
PSC = primary sectoral contribution,
CPI = consumer price index,
DV = dummy variable, i.e., '0' represents 1960-1975 and '1' represents 1975-1993, and
u = random error term.

Further, we adopted step-wise regression analysis to overcome the problem of multi-collinearity and necessary equation for the analysis is selected on the basis of (i) higher $R^2$ value and (ii) large number of significant explanatory variables.

The Chow Test (1960) is employed to test the influence of change of political stability to instability on the stability of the determinants of impact of personal income taxation on distribution of income and influence of socio-economic, demographic and political factors on personal income taxation and it is defined as follows:
\[
F = \frac{RSS_p - (RSS_1 + RSS_2)/K}{(RSS_1 + RSS_2)/(n_1 + n_2 - 2K)}
\]

which follows F distribution with K and \(n_1 + n_2 - 2K\) degrees of freedom.

Where,

\[RSS_p = \text{residual sum of squares of pooled regression equation},\]
\[RSS_1 = \text{residual sum of squares of the first set of regression},\]
\[RSS_2 = \text{residual sum of squares of the second set of regression},\]
\[n_1 \text{ and } n_2 = \text{sample size, and}\]
\[K = \text{number of regressors}.\]

Sources of Data

The present study is purely based on secondary data. The data used in the above analyses are obtained from All India Income Tax Statistics, Public Finance Statistics, Economic Surveys, Publications of Ministry of Finance, Budgets and Census Reports, Reserve Bank of India Bulletins and Reports on Currency and Finance for various years.
Period of Study

The study covers a period of 33 years from 1962-63 to 1995-96. However, in respect of analyses related to elasticity and buoyancy, burden and distribution, the period extends only upto 1988-89 due to non-availability of comparable income range-wise data for the rest of the years. The period from 1962-63 was chosen meaningfully taking into account the current Income Tax Act 1961 that came into effect from 1st April 1962.

Scheme of the Study

The study encompasses seven chapters and they are presented below:

Chapter I introduces the problem, objectives, methodology and the plan of the study.

Chapter II reviews the literature pertaining to the study area and identifies the gap of the study.

Chapter III presents the trend, pattern and growth of personal income taxation in India.

Chapter IV analyses the elasticity and buoyancy of personal income tax across different income ranges.

Chapter V examines the burden, progressivity and the
impact of personal income taxation on income distribution. Besides, it attempts to identify the determinants of impact of personal income taxation on income distribution.

Chapter VI deals with the determinants of personal income taxation and the impact of structural disturbances on the stability of the determinants of personal income tax.

Chapter VII sums up the findings and projects the policy implications and the scope of future study in the area of personal income taxation.
REFERENCES


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