CHAPTER 2

THEORIES AND PRINCIPLES OF INCOME TAXATION

2.1. Theories and Principles

Taxation is not a new concept. Actually 'Taxation' found its expressionin the time of Kautilya, father of the Indianeconomic science, when people suffering from anarchy, elected Manu to be their king and deposited one-sixth of the grains and one tenth of the merchandise in the form of dues. It was the duty of the king to maintain law and order and to protect the people, while people were asked to pay taxes in return. It is believed that even during the ancient days, state's activities were very wide and taxes were realised from almost all the possible sources. But the king was not supposed to violate the principles of just taxation[1]. He was supposed to determine the limits in taxation and with the aid of his financial ministers to fix the time and amount of taxation. The Manusmriti also laid down that taxes should be levied in accordance with the provisions of Shastra[2]. Thus, restrictions were found in the state financial management, Kautilya has also presented valuable thoughts relating to the state financial management. In the sphere of governmental taxation, his work is supposed to be the oldest financial work not only in India but all over the globe[3]. Taxation was considered as a policy and the king had to act very wisely. He was supposed to know when to tax, whom to tax and how much to tax. Therefore, this was the time when it was considered that the policy of taxation should be based on some theories or principles. Actually, Manusmriti goes a long way to maintain the principle of convenience or ability to pay, while managing taxes. Vasudeo also stated that, Manusmriti stresses a good deal, particularly in respect of anatomising and optimising the tax structure, on the basis of ability to pay[4]. Thus, different canons of taxation were in practice, albeit during the ancient days[5]. In ancient times, before levying a tax the government used to consider certain practical considerations, like the nature and urgency of the new tax, cost of administration for the collection of the tax and also the capacity and convenience of the people, who had to bear the burden of tax. Thus, Theories of taxation not only concentrated on raising the quantum of revenue for the government but also took proper care of the social justice and welfare of the people.

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1. Sarkar, K.R., Public Finance in Ancient India, Abhinav Publications, New Delhi,1978.P.61
2. Jha, D.N., Revenue system in Post-Maurya and Gupta Times, Calcutta, 1957.
3. Jha, S.M., Taxation and the Indian Economy, Deep & Deep Publications, New Delhi, 1990, PP.25.
4. Vasudeo, R.Sharmano, Manusmriti, Bombay, P-139.
5. Jha, D.N., Revenue System in Post - Maurya and Gupta times op. cit., P-23.

The concept of taxation started right from the 15th century and principles of social justice or aggregate welfare were also practised. It can be said that the modern thinkers have not given a new life to the principles of taxation. But it can not be ruled out that from the ancient time to the modern age, the concept of taxation has changed a lot. Taxation has been associated with many historic developments. In its origin, taxation was a means to sustain the survival of the state but now it has become a means to vitalise economic development. Economic welfare has become integral part of economic development. Taxation, which was only an unpleasant incident because monarchs and rulers never took seriously the sacrifice element on the part of tax payers,has now become a dominating feature of daily life. Modern governments have occupied the status of a 'Welfare' state rather than a 'Police' state. All these initiated a basic change in the concept of taxation.

Since, with the passage of time, responsibilities and functions of the state have increased many times, the financial requirements of the state have also risen to a larger extent. The inclusion of new functions left no option to the state but to generate the financial resources through taxation. Since, by its very nature of being a compulsory charge without a direct quid pro quo (benefit), tax imposes a sacrifice on tax-payers. Therefore, although the government has coercive power to tax anything on earth and there is no limit to this power, it is necessary that certain principles should be followed by the tax authorities before devising a tax system, since a tax-system has far-reaching effects on the economy. Whenever the principles of taxation are referred to, majority of people think instantly of the famous four canons of Adam Smith, the father of economic science. A sound tax-system is one which adheres to these famous canons. These canons are called fundamental principles of taxation. These have indeed performed nobel service in economic thought and teaching for over a hundred years. The most elaborate modern principles are really found in essence in Adam Smith's plain phrases. These fundamental principles are explained below :

(1). Canon of Equity or Ability :

This canon of equity implies that the criterion of payment of taxes should be the ability to pay and the sacrifice caused by taxation should be equal for everybody. The principle is stated by Adam Smith in the following words :

"The subject of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the

protection of the state[6].”

Thus according to this canon tax system should be based on the principle of social justice. Since it stresses on the payment of tax according to the capacity of the tax-payer to pay tax, it is in favour of progressive tax-structure. For satisfying the canon of equity, it is necessary to charge higher incomes at a higher rate of taxation.

(2). Canon of Certainty :

This canon implies that tax payer should be certain about the quantum of tax to be paid. Tax rates should be certain, items of taxation be precisely defined; and no discretionary power be left to the tax collecting officials because uncertainty of any kind may result in fraud and corruption . The tax payer might defraud the state by not paying his due tax in full, although he could afford to pay; or the tax-collectors might oppress the tax-payers by exacting more out of them.

Adam Smith states this principle in the following words :

> **“ The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the quantity to be paid, ought to be very clear and plain to the contributor and to every other person[7].”**

Importance was given to an accurate survey and record of the income since it was necessary to secure certainty in taxation. Certainty in taxation also means that a government should be able to estimate the probable yield of a tax with a certain degree of accuracy, so that the expenses can be managed according to the revenue or the purpose for which the tax is being levied is fulfilled.

(3). Canon of Economy :

Economy principle implies that the cost of collection of tax should be kept as low as possible. A major portion of a tax revenue consumed in collecting the tax will reduce the net revenue yield of the government from tax and the tax wouldn't be economical. Economical taxes promote economic efficiency.

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6. Wealth of Nations (Canon's edition), Bk, V, Ch.II, Part II. P. 777.
7. Ibid., P. 778

In the words of Adam Smith :

" Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings in to the public treasury of the state[8]."

The Canon of economy is also capable of another interpretation. The payment of a tax means inconvenience and disadvantage to the tax payer i.e. real cost to the tax payer. It is in this sense that Smith has used 'cost' also. So the cost includes money cost as well as real cost. Therefore, economy may mean lowest possible money cost of collections to the govt. and least possible inconvenience and disadvantage to the taxpayer.

(4). Canon of Convenience :

This canon implies that the time and mode of payment of a tax should be such as to cause the minimum inconvenience to the tax-payer.

Adam Smith lays down :

"Every tax ought to be levied at the time and in a manner in which it is most likely to be convenient for the contributors to pay it[9]."

Adam Smith's canons of Taxation are as sound today as they were in 1776. There has only been extension and modifications of these canons by the economists due to the change in objectives of taxation policy. In 19th Century the work of David Ricardo, Mc Cullochs, J.S.Mill, H.C.Adams and E.R.A. Seligman gathered wider appreciation. But the classical economists failed to realise the advantages of public expenditure over taxation. They advocated that the best of all taxes is that which is least in amount. But in the end of 19th Century and the beginning of 20th Century importance was given to the concept of welfare as the economists as well as social scientists wanted to integrate development concept with the welfare concept. It was argued in 1940's by the American disciples of Keynes that the specific function of taxation was the regulation of the overall level of economic activity by altering the amount and composition of taxation in relation to public expenditure.

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9. P - 778 (Wealth of Nations).

Today, the principle of taxation is linked with its objectives. Objectives may vary from time to time or from stages to stages, therefore, changes in taxation policy can't be ruled out. The latter day economists did not support the maxim that the very best of all taxes is least in amount because of the increased functions of the government. It was not important that how we minismise the taxes but how the burden should be distributed to minismise the magnitude of social sacrifice.

The Sacrifice or Ability to Pay Approach :

The sacrifice (or ability to pay) approach came into existence which was an extension of the canon of equity suggested by Adam Smith. In his first canon i.e. canon of equity, he talks of contributions 'in proportion to the revenue which they enjoy under the protection of the state' (benefit) and also in proportion to 'respective abilities ' (ability to pay). It appears that he combined the benefit and the ability-to-pay principles of equity in the distribution of tax burden.

The ability-to-pay approach has been advocated by many economists such as John Stuart Mill, Edgeworth, Pigou and Dalton. This approach has its own importance as it takes in to account the distributional aspect and is based upon the principle of equity and justice. According to this approach, taxes should be distributed in accordance with the ability of the individual to pay tax.

The payment of taxes to the public sector constitutes a sacrifice to the taxpayer in terms of foregone alternative uses of money paid in terms of taxes. The ability-to-pay principle determines equity on an equal-sacrifice basis. It suggests that all taxpayers should bear an equal sacrifice in the payment of taxes. This principle of equity or principle of equal sacrifice in its barest form asserts that similar persons should be treated similarly i.e. individuals of equal taxpaying ability should be taxed equally. This concept is called "Horizontal Equity" in taxation. The concept of 'Vertical Equity' in taxation states that individuals with unequal taxpaying ability should be taxed 'Unequally' in order to equalize the sacrifice. Those who have high incomes or greater ability to pay should contribute more toward government then those who have low income or low ability to pay. This principle justifies the case for progressive taxation. Although horizontal and vertical equity are keys to tax fairness and make intuitive sense, these ideas are difficult to apply because it is not easy to tell when people are in 'similar' circumstances and when in 'different or unequal' circumstances. While Mill suggested 'equal sacrifice' for different tax payer, Pigou has suggested 'least aggregate sacrifice'. Although there are several versions of the ability-to-pay principle but none could provide an explicit definition of the "ability". Generally, income has been taken as a primary indicator of ability to pay though to a lesser extent, wealth comparisons have also been used. The higher the income of an individual, the more able he is to pay taxes, similarly, the greater the amount of wealth possessed, the higher the ability to pay. The measurement of ability depends upon inter-personal comparisons of sacrifice to determine the tax burdens of different persons. But such comparisons are difficult, if not impossible.

The ability to pay approach thus can be viewed in terms of three sacrifice concepts: (1). equal absolute sacrifice, (2). equal proportional sacrifice, and (3). equal marginal sacrifice.

Vertical tax equity, in terms of absolute sacrifice requires that a tax imposed would cause equal amount of utility sacrificed from all the individuals. The equal proportional sacrifice concept means that a tax should cause each individual to give up the same percentage of total utility in order to reach vertical equity, i.e. equal proportions of disutility to total utility. Equal marginal sacrifice principle is that individuals should give up the same marginal utility when they pay taxes. Given utilitarian assumptions, an equal marginal sacrifice tax is both fair and efficient. Equal marginal sacrifice leads to minimum total sacrifice (least aggregate sacrifice)- a tax that lowers total utility less than any other.

The ability-to-pay concept, given the above assumptions, implies that the ability to pay tax increases more than proportionately with increases in income, because the marginal utility of income declines at an increasing rate as income increases. Therefore, in order to maintain equal sacrifices among taxpayers, the marginal rate of taxation must increase as the income base increases. The utilitarians maintain that satisfaction or utility can be measured and compared between individuals. They believe marginal utility of money declines as income rises and preference schedules of taxpayers are homogeneous, that is, the utilities of individuals are the same within a particular income level. Therefore, higher income individuals should pay more taxes than lower income individuals so that the marginal sacrifice for all the individuals remains equal. This concept of equal marginal sacrifice suggests a highly progressive income tax rate structure. Although modern economists are not agreed that utility is measurable and comparable among individuals, utilitarian concept influence many public policies. The equal marginal sacrifice principle, with its progressive tax prescription, must be treated as a legitimate view of tax equity, which exert important influence on the thought of policy makers. As Pigou states "In order to secure least aggregate sacrifice taxes should be so distributed that the marginal utility of the money paid in taxation is equal to all the tax payers. Thus the distribution of taxation required to confirm to the principle of least aggregates sacrifice is that which makes the marginal not the total-sacrifices borne by all the members of the community equal[10]."

The Benefit Principle

An alternative principle for the distribution of the tax burden among individual taxpayers is based on the benefits received from the enjoyment of public services. This principle relates to the distribution of taxes by taking in to account the sacrifice of the taxpayer in paying his taxes along with the benefits he enjoys from governmental expenditure. This approach have been advocated by many persons, such as Pantaleoni Mazzola, de Vitide Marco, Sax and Lindahl, in one form or another. Adam Smith also, in his first canon of taxation mentioned this principle.

However, the benefit principle is not a satisfactory explanation and objections are raised against it because of the practical difficulty of correlating and measuring the amount of benefit enjoyed by a tax payer and his tax payment. Further, it is very difficult to find out how intensely a particular taxpayer wants a particular service from the government and how much he is prepared to pay for it. Then, as Musgrave has pointed out, the true preferences of consumers (tax payers) for different public services which satisfy social wants (because public services are consumed equally by all) can not be revealed. A person may not be prepared to indicate his preference for such social wants and may not be willing to pay for them if he knows that the government will provide the service even if he does not pay. Then, as Prof. Buchanan states that there appears no precise manner of imputing shares of the aggregate common benefit from government expenditure to specific individuals. Therefore, although this principle has the logical advantage, practical imputation of this theory is not possible. Since in modern state, taxes by their very definition are compulsory payments which are not based on any consideration of return or benefit enjoyed by the taxpayers. This principle is of little importance.

The Principle of Maximum Social Advantage

This principle of Maximum Social Advantage is given by Pigou and Dalton. They extended the ability-to-pay principle to include the benefits of public expenditure. This principle seeks to balance the social advantage of public expenditure and the social sacrifice

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10. Pigou, A.C. A study in public finance, Mc-millan & Co. Ltd., London, 1962. P.57.

involved in the payment of taxation. Pigou called this principle as the Principle of Maximum Aggregate Welfare,[11] while Dalton explained it as the Principle of Maximum Social Advantage[12].

According to this principle, economic welfare of the community is the goal of state's economic policy. But the problem is how to determine the measures which will lead to maximum social advantage. The answer to this question depends, according to Dalton, on further three questions and their answers. First question is that, how far should taxation and public expenditure be carried? The answer suggested by him is : that "public expenditure in every direction should be carried just so far that the advantage to the community of a further small increase in any direction is just counter balanced by the disadvantage of a corresponding small increase in taxation or in receipts from any other source of public income. This gives the ideal both of public expenditure and public income[13]". The ideal point to which taxation and expenditure should be pushed is that at which marginal utility of government expenditure is just equal to the marginal disutility from taxation. Or, as Pigou states, "Expenditure should be pushed in all directions up to the point at which the satisfaction obtained from the last shilling expended is equal to the satisfaction lost in respect of the last shilling called upon government service[14]."

Second question is that, how should public expenditure be allocated among different uses? The answer to this question is that expenditure should be incurred in different uses in such a way that the marginal utility obtained from each use is the same. This is the principle of equimarginal utility or principle of maximum satisfaction.

Third measure on which the maximum social advantage depends is the answer to the question, how should taxation be divided among different sources or how should the burden of taxation be divided ? The answer is that the total sacrifice upon the people will be the least only when the burden of taxation, among the different sources, is divided in such a way that the marginal sacrifice from taxation of each source is the same.

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11. Ibid.
12. Dalton, H., Principles of Public Finance, Routledge & Kegan Paul Ltd., London, 1954.
13. Ibid., P. 142.
14. Pigou, A.C., op cit., page 31.

These considerations, although, are theoretically right but very difficult to apply in practice. As Musgrave puts, "Many modern 'welfare economists' believe that inter-personal comparisons of utility or sacrifice are not possible [15]." Such comparisons are also not possible as far as the government expenditure and taxation is concerned because, in actuality, government is spending and taxing vast number of people and different departments at different places are involved. Then it is not possible to compare the additional utility derived from the spending of one more rupee on any public investment with the additional sacrifice imposed by a tax of one rupee on any individual. Dalton himself recognised, "This is a difficult calculus, but that statement must handle it as best as they can, since there is no practical alternative[16]".

Dalton, however, himself suggested some tests of social advantage. First test is the preservation of the community from internal disorders and external attacks. Second test for an increase in the economic welfare of the community is improvements in production. Improvements in production means (i) increase in productive power, i.e. a larger product per worker with a smaller effort, (ii) improvements in the organisation of production, and (iii) improvements in the composition, or pattern of production. Third test is improvement in distribution, i.e. a reduction in inequality and fluctuations in the incomes of individuals and families. Fourth test is the maintenance of economic stability. Fifth test is maintenance of full employment and the provisions for the future needs of the community.

In spite of practical difficulties, the principle of Maximum social Advantage maintains important place and taxation policy should follow this principle. Since this principle takes in to account both benefits and costs of public expenditure, includes welfare aspect and is based upon the principle of equity and justice, this principle is comparatively good.

Since, sacrifice or burden of taxes, like welfare or utility, is a mental phenomenon, therefore, there is no satisfactory or commonly accepted method of measuring it. Government can judge its policy itself on the basis of its experience and above mentioned 'tests',because it is quite possible to arrive at the above 'tests' without going through the difficult exercise of making inter-personal comparisons of marginal utilities and marginal sacrifices. A good deal depends on intution rather than on measurement in such cases.

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15. Musgrave, Richard A., The Theories of Public Finance, McGraw Hill, New York, 1959.
16. Dalton, H., op. cit., P. 142

Since the functions of the government have increased many times from the days of Adam Smith and taxation policy is judged today on the basis of its effects on various aspects of economic life- on production, distribution, the level of economic activity and employment and on vital non-economic aspects, it is, therefore, pertinent to add a few more principles of taxation. These are :

Principle of Productivity :

According to the principle of productivity, a tax should produce for its government sufficient revenue to justify its imposition. Since government's expenditures are increasing due to its multifarious activities, it is essential that taxes should be productive, i.e. they should generate more and more revenue.

A government should select a few taxes the yield from which will be sufficiently large, in place of several taxes, to avoid high cost of collection. This is a very narrow sense of productivity which only means the revenue to the government exchequer without taking in to account its effects on production in the national economy. Concentration of taxes on a few sources may affect nations productive activities adversely. Then taxes will be called productive when they yield large revenues for the government, not only in very near future but in the long period also and does not affect productive activities adversely. Taking in to account all these meanings, productivity is certainly a desirable aim for taxation.

Principle of Elasticity or Flexibility :

There can not be any dispute about this principle. Tax system should have the capacity to adjust itself with the dynamic conditions. The tax system should not be rigid. It should be able to cope with the changing needs of the government, the changing conditions and problems of the taxpayers and the changing nation's economy. The tax system should be capable of revision and amendments as the circumstances demand.

Principle of Simplicity :

Tax system should be simple. Tax laws should be clear and easily understandable to a common man. Simplicity reduces the cost of collection of taxes and inconvenience to the tax payers. Simple tax system can avoid corruption in tax administration also to some extent . Taxes should be assessed on an obvious base easily arrived at, levied at moderate rates and payable in a convenient manner.

Principle of Diversity :

Although taxation based on few sources is more productive from revenue to the government point of view but it is also necessary that there should be diversity in taxation. If the number of sources will be large, there would not be any uncertainty about revenue collection. Moreover, diversity also satisfies the canon of equity. It is equitable to diversify sources of taxation to cover as many people and as many items of taxation as possible, instead of putting the burden on few people.

Principle of Consistency with Economic Goals :

Policy of taxation should be consistent with economic goals of the country. Growth with stability and social justice, raising sufficient funds for state exchequer, promoting savings and investments, reducing inequalities, etc. are some important economic goals. But these economic goals differ from country to country. Economic problems in developing countries are different from developed countries. Even social, economic and political conditions as well as historical backgrounds are different. Because of the differences of institutional and historical backgrounds their tax systems should also differ from one another since these factors affect economic goals of the country.

In developed countries, stabilisation is the main economic goal while in developing countries, the development of resources is the overall objective. In developed countries, ability and equity are the guiding principles of taxation while in developing countries productivity and administrative practicability are the leading principles of taxation. Inequalities of income and wealth are more glaring in developing countries than developed countries, though the principle of productivity and equity may conflict with each other. Income tax brings less revenue to the government due to low national income and low per capita income in developing countries than developed countries. Thus, problems of these two types of countries are different. Therefore, economic goals and hence tax systems should also differ.

But these differences in the goals, or in the system of taxes that a country may have, does not mean that there should be separate principles or theories of income taxation to suit the needs of different countries. The basic or the fundamental principle of taxation is applicable to the tax system of any country so long as they use the term tax in the same sense and meaning that has come to be associated with it. Government may be under various kinds of influence or pressures in determining the tax policy, as a result of which it may not be possible to pay much attention towards the niceties of the principles or theories, but the difference is only of degrees and some deviation becomes unavoidable. These principles should always be kept in mind while determining taxation policy.

Importance of Income Taxation

Income tax is very desirable. Since income is considered to be the most satisfactory index of ability to pay which can be subjected to progressive rate schedule, income-tax is the most important of all direct taxes. Income tax can be made not only to satisfy all the canons of an ideal tax system but may also go a long way in realising variety of socio-economic objectives set out by the economic policy of a country.

A properly designed income tax would help to achieve the goal of economic development through generating more revenue for the government as income tax is more elastic. "Nevertheless," in the words of Musgrave and Musgrave, "the Income tax should be established early and strengenthed as development proceeds. It is elastic to growth in GNP (Gross National Product) and, therefore, a promising revenue source for development finance".[17] When tax revenue would rise automatically, tax laws would not have to change from year to year and there will be less uncertainty for people in making investment decisions. More stability in the tax system would create a more certain business climate. Also, Income tax, by generating stability in the tax system, acts as a built-in stabiliser.i.e. ,income tax acts as a cushion against an excessive upward or downward movement-movement in income and prices. Extra purchasing power, through higher rate of tax, is taken away during a boom period and vice-versa.

Income tax, on individuals,is an important direct-tax and is preferred to any other tax as it is more equitable, administratively effective and can be related to individual's ability to pay . Also, as Due observes, " The income tax meets requirements of equity more satisfactorily than other taxes so long as it can be enforced ----. The tax can also be employed to encourage certain uses of income, such as re-investment within the country, and to discourage others, such as sending capital abroad[18]".

Since income-tax alone fails to yield adequate revenue to the state - particularly in developing countries - they have to rely upon indirect taxes also. In an underdeveloped

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17. Musgrave, R.A. and Musgrave, P.B., Public finance in Theory and Practice, McGraw Hill Kogakusha Ltd., London 1980, P.803
18. Due, J.F. Government Finance Economic of the Public Sector, Richerd D.Irwin, Illinois, 1968, PP.462.

economy, like India, the welfare and growth requirements compel the state to raise more revenue through more and more indirect taxes, which may be of regressive type to some extent as they are in general more easily shifted, all too frequently to those who are least able to bear them.

Second hindrance in the path of income tax being effective in developing countries is the lack of proper measurement of income. Presence of a large subsistence sector, in which the output of family is consumed at home and there is no obvious way of valuing the home-consumed production, and the presence of barter system, pose the problems in measuring income.

Third problem with income taxation in developing countries is that of the ease of administration, which, to a large extent depends on the average payment of tax relative to the cost of collection from each tax payer and the existence of records. A large portion of population covered by income tax which includes many low-income individuals, results in small tax collection comparative to the cost of collection. The absence of large firms in low-income countries hinders tax administration considerably. Small firms and business with inadequate records of interim transactions pose the problem in adequate measurement of their income.

In spite of the above mentioned problems which developing countries have to face, income taxation does not lose its importance. These problems can be solved by better tax-administration. Better and honest administration would lead to less cost of collection and large collection of tax revenue. Efficient tax laws would check tax evasion. A high degree of fairness in the tax system encourages individuals to file their income-tax returns voluntarily. Tax-reforms can definitely raise the revenue from income-tax.

Optimal Income Taxation

We have considered, till now, that income taxation is desirable, and now presently we see what is the optimal way to structure an income-tax. The main objective of optimal taxation theory has been to identify that policy which enables the government to secure revenue for socially worthwhile expenditures with the least sacrifice of economic well being. The goal of optimal income taxation in the utilitarian studies was to make the sum of individuals' utilities as high as possible, subject to the revenue required. That meant maximisation of social welfare. Edgeworth (1897) examined the optimal income taxation, assuming identical utility functions of individuals which exhibit diminishing marginal utility of income (utility functions being dependent upon the levels of income), fixed total amount of income available and the objective of maximising the sum of individual-utilities subject to required revenue. Maximisation of social welfare, after the payment of tax, requires equimarginal sacrifice by the taxes (principle of minimum aggregate sacrifice or equimarginal sacrifice). We have already discussed that a system of equimarginal sacrifice would emerge when incomes are leveled off from the top through taxation until complete equality is reached. Edgeworth's model implied progressive tax structure and 100 per cent marginal tax rate on high income individuals. In other words, the cost of obtaining more equality was taken zero in Edgeworth's model. Since the system of equimarginal sacrifice demanded high marginal rates of tax on high income, the objective was only of 'equality' that means the disincentive effects of high marginal rates of tax– people would not be interested in earning high incomes knowing that it would be taken away by the government– were ignored. Therefore, the importance of trade off between equity and efficiency or incentive was realised. Then, the assumptions in Edgeworth's analysis were also not acceptable. The assumption that the total amount of income available to society is fixed, is far from reality and not correct because it means that the tax rates have no effect on the level of production. Further, the utilities of individuals not only depend upon income but upon leisure also.

In recent years there has been a substantial growth in the literature of optimum income taxation, also called the modern literature. Although, Sidgwick (1883) pointed out the disincentive effect by stating that a greater equality in the distribution of produce would lead ultimately to a reduction in the total amount to be distributed in consequence of a general preference of leisure [19], the first decisive step to incorporate incentive effects in a model of income tax and to give the optimal income tax schedule was taken by Mirrless (1971). Mirrless incroporated the analysis of the different supplies of labour brought about by the alternative tax schedules into a welfare maximisation formulation. In other words, in Mirrless formulation, the objective of the government is to maximise social welfare, which is a function of the level of welfare of each individual, subject to a revenue constraint. Individuals can alter their behaviour depending on the tax system, particularly regarding the supply of labour. High marginal tax rates may reduce individuals' supply of labour and therefore total output. Therefore, equity and efficiency often are contrasted. The greater is the labour supply response to high tax rates, greater is the efficiency cost per unit of revenue raised. Optimal income tax system balances equity gains against efficiency losses. Mirrlees' studied that optimal tax

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19. Sidgwick, H., Principles of Political Economy, Macmillan, London, 1883.

schedule depended upon the distribution of skills or abilities (on which wage rate depended) and the labour-consumption preferences which are altered by the levy of income tax. With a simple utilitarian social welfare function, distribution of ability or wages and an identical Cobb-Douglass utility function of goods and leisure (elasticity of substitution is equal to one) for each individual, he arrived at mainly two conclusions; firstly, the optimal income tax schedule is approximately linear, i.e., constant marginal tax rates across the distribution allowing a positive lumpsum to be paid to the low income earners and, secondly, not very high marginal tax rates, in the range of 20 to 40 per cent.

But, Mirrlees' model of optimum income taxation was highly complex and abstract, and offered us little concrete guidance in the construction of a tax schedule. He himself wrote about the abilities of individuals and the labour they put in "Neither is easy to estimate for real economics[20]."

The seminal work in the area of optimal income tax by Mirrlees was followed by Sheshinski (1972), Atkinson(1973), Sadka (1976) and Seade (1977). If Mirrlees' model was the labour model where the income of an individual depended upon the number of hours he worked, Sheshinsky's model was education model where the level of education determined one's income. Income tax has an effect on the incentive to work or on the incentive to obtain education and consequently on the national income, and an effect on the distribution of after-tax income. That way, efficiency and equity consideration can be integrated in policy analysis and the equity-efficiency trade off can be formalised. Sheshinski's study is concerned with the effort to trace out which linear income tax schedule will be optimal among all linear tax schedules.

Seade (1977) has also drawn the same result assuming the utilitarian type of social welfare function. Atkinson (1973) explained that the degree of progressivity of an income tax schedule depends on the type of social welfare function we select. He further showed that the optimal marginal tax rate is, approximately, 50 per cent and if one is concerned with maximising the welfare of the worst off individual as explained by Rawls (1971), the marginal tax rate would be considerably higher for most of the income range. Utilitarian analysis was criticised by Rawls (1971) whose study was concerned with the maximisation of utility of the worst off members of the society. He adopted two basic principles of justice. Firstly, liberty has priority

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20. Mirrlees, J.A., An Exploration in the Theory of Optimum Income Taxation, Review of Economic Studies, 38, 1971, P.207

among all goods distributed and secondly, inequality in welfare will be allowed only if and to the extent that it serves to increase the well being of the poorest persons of the society. By adopting the Rawlsian objective Phelps (1973) has shown that the optimal income tax should be regressive as to maximise the welfare of the worst-off individuals; he aims at the maximisation of the tax potential and then to redistribute these proceeds in a lumpsum manner among the persons.

Pulin B. Nayak (1975) introduced public goods in to the model of Sheshinski. He considered that provision of public goods is financed by linear income taxation. "It is shown that the optimal tax parameter is chosen such that the utility gain in the consumption of private goods at the margin should exactly be matched by the utility loss due to the reduction in the provision of public goods[21]."

Sadka (1976) has demonstrated that maximisation of social welfare or the optimal marginal tax rate requires the marginal tax rate to be zero at the highest income level. He also proved that optimal tax can not be progressive every where.

Seade (1977) has also drawn the same result that the highest earning household is better off under the zero marginal income tax rate scheme compared to an income tax system in which the marginal tax rate is positive and that raising the marginal tax at the top from zero affects the labour supply decision of the highest earner negatively and raises no revenue.

Stern in 1976 studied a model similar to Edgeworth, except including leisure. He proved how results change when work incentive is taken in to account. He explained that individuals make choices between income and leisure. He further explained that if income of an individual is zero, his 'tax burden' will be negative as government will provide a lumpsum grant to him. The problem of optimal income-tax, according to him, would be to find the best combination of the marginal tax rate and the lumpsum grant. His study was also based on a linear income tax schedule which is often referred to as a flat tax. By allowing a modest amount of substitution between leisure and income, and with required government revenue, he proved that the marginal tax rate which maximizes social welfare is less than 100 per cent implied by Edgeworth's analysis. He further explained that the degree of labour supply responsiveness implied by Cobb-Doughlas utility function is excessive with an elasticity of substitution equal to one and therefore, overstated the costs of increasing tax progressivity. With more reasonable

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21. Nayak, Pulin B., Essays in Optimal Taxation, Common Wealth Publishers, New Delhi, 1990, P.7

estimated elasticity of substitution equal to 0.4, he claimed that the value of the optimal tax rate will be higher than those found by Mirrlees. According to his result the optimal marginal tax rate of a linear tax system is 54 per cent.

But Stern's estimate for the elasticity of substitution equal to 0.4 was also challenged by Hausman(1981) whose econometric work indicates a substantially higher elasticity of substitution.

Stiglitz (1982) developed the theory of optimal income taxation by assuming two classes of taxpayers. The redistributive tax system imposes a zero marginal tax rate for the high-ability individual and a positive marginal tax rate on low-income individual. According to him, the tax schedule is designed in such a way that each individual tax payer prefers that consumption-labour choice which the tax planner intends him to choose. A large numbers of required tax parameters make this approach impractical.

J. Slemrod, Yitzhaki and Mayshar, and M.Lundhom (1994) investigated the optimal two-bracket linear income tax. Although most of the previous studies resulted in zero marginal tax rate scheme for highest-earning individual, this result is not practically significant. Even Mirrlees (1976) suggested, on the basis of numerical calculations that zero was a 'bad approximation to the (optimal) marginal tax rate'. But regarding optimal two-bracket linear income tax, their work suggested that the second marginal tax rate lying below the first. But J. Slemrod, Yitzhaki and Mayshor, and M.Lundholm (1994) have demonstrated "in a much more general setting that efficient income tax structures may exhibit either declining or increasing marginal tax rates, contrary to earlier work which purports to demonstrate the sub-optimality of declining marginal rate structures[22]."

Sheshinski (1989) also presented a proof that a declining rate structure can never be optimal.

The present survey of the literature on optimal income taxation points out that marginal income tax rates should be low, we should avoid progressivity and impose a marginal income tax rate of zero at the highest income level. Modern theory of optimal income taxation has analyzed a tax system that minimises the efficiency cost and trades off the inefficiency and social benefit of a more equal distribution.

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22. Slemrod J., Shlomo Yitzhaki and Joram Mayshar, Michael Lundholm, "The Optimal two-bracket linear income-tax," Journal of Public Economics, 53, 1994, P.286

Although optimal tax theory made several very important and lasting general conceptual contributions to economic theory as well as gave us guidance into thinking about the optimal level of tax progressivity, yet wide range of other issues that must be considered in determining the optimal degree of tax progressivity have been ignored. The basic models have been expanded to see how optimal tax rates are affected by new complications. Boskin and Sheshinsky (1978) examined the implications of interdependent utilities, i.e., the utility of each individual depends not only on his own income, but upon the income of other individuals. Eaton and Rosen (1980a) studied how people's uncertainties about their future incomes affect optimal tax rates.

In real-world, income tax systems are different from the systems suggested by optimal income tax literature. Far from having zero marginal tax rates at the highest incomes, actual tax systems tend to tax these incomes at the highest rates. In place of regressive or proportional, progressive income tax system is being adopted. The personal income tax schedule is progressive and this (step wise) progressivity is ensured by increasing marginal tax rates for successive income brackets. This is so, because optimal taxation is a purely normative theory. It is not able to predict what real-world tax systems have to face and how it is affected by many factors which can not be estimated accurately. The answer depends to a large extent upon value judgements, and the tools of economics do not provide definitive answers to ethical questions. The theory pays little attention to the institutional and political setting in which tax policy is made. Actual tax systems may look more reasonable when political realities are taken in to account than they do from an optimal tax point of view.

The optimal income tax framework rests upon many unrealistic assumptions like homogeneous cardinal individual utility functions.

The optimal income tax literature generally analyses the effect of changes in the taxation of wage income on social welfare. But in a multiple tax system it is not possible to define or measure the optimal progressivity of only income tax schedule.

The assumption of zero administrative and compliance costs of personal income taxation makes the basic models of the optimal income tax theory doubtful. Until recently, it was ignored that gathering the taxes required resources of the taxing authorities. Also government had to spend a lot to employ persons for tax administration. At the same time, taxpayers incur costs in complying with the tax system. They have to spend for the services of accountants and tax lawyers. Value of their time spent on filling out tax returns and keeping records is also a part of their compliance costs. Optimal or most efficient income-tax system may be considered undesirable if it is excessively complicated or expensive to administer. In a recent development Mayshor (1991) and others have included the collection costs in the theory of optimum income taxation. But an accurate model of optimal income taxation demands for an accurate estimate of administrative cost and compliance cost, which has not been possible.

The assumption of 'no evasion' also makes the theory of optimal income taxation impractical. 'Cheating' is one of the most important problem faced by tax administration. Tax evasion, i.e. non-payment of taxes legally due, by its very nature,is extremely difficult to measure. Because of tax evasion, tax collections are reduced and tax returns can not be estimated accurately. Tax evasion affects taxation policy and, therefore, can not be ignored. In a recent study, J. Slemrod (1994) has examined optimal income tax progressivity when avoidance (including evasion) responses to taxation are important, and can be controlled at some cost by the government. He analysed optimal income tax progressivity in an economy characterised by both kinds of behavioural response to taxation,i.e, avoidance response and labour supply response. There is a difference between an optimal progressivity model with avoidance and one with only a labour-leisure trade off, since the former kind of leakage can be controlled to some extent by government policies through expenditure on enforcement, i.e., the cost of the tax avoidance. The optimal progressivity of the income tax cannot be separated from the problem of optimal enforcement. Slemrod concluded that both kind of leakage increase the social cost per unit of redistributing income and lead to decline in optimal progressivity higher avoidance elasticity as well as higher labour supply elasticity lowers the optimal marginal tax rate because it increases the marginal resource cost per unit of revenue raised for an increase in tax rate.

There can hardly be any dispute that the literature on optimum taxation has helped in clarifying the objectives and implications of taxation in a better way than before and on some occasions, has corrected previous errors. Optimal tax analysis has clarified the trade-offs between efficiency and equity in tax design because of which various definitions of " equity " have been scrutinized. In recent years, the 'basic principles' of taxation have been integrated with the principles of welfare economic and the optimal tax literature derives the criteria for a good taxation system using an underlying social welfare function.

But a proper understanding of the models of optimal taxation suggests that the computation of tax rate or tax schedule calls for a large amount of information and understanding of the parameters of the economy, such as the degree of inequality in the abilities and capacities among the people, behavioral responses to progressivity, parameters of the relevant utility and social welfare functions, administrative and compliance costs, and the level of tax evasion. In real life, it is very difficult to have accurate information about these parameters and , therefore, to be able to compute the optimal tax rates.

Although the optimal tax approach points out that the concept of horizontal equity is difficult to make operational, the fact remains that equal treatment of equals, which horizontal equity means, is an appealing ethical concept, and there is as yet no other way of achieving equity except through the progressive income taxation - of which an initial exemption limit is usually the first step. Ability-to-pay approach still survives. Joseph Pechman (1990), in his presidential address to the American Economic Association, stated regarding income-tax progressivity , " most people support tax progressivity on the grounds that taxes should be levied in accordance with ability to pay, which is assumed to rise more than proportionately with income. Economicst have....... had trouble with the 'ability-to-pay' concept.......... I believe that the person on the street is right and that we should continue to rely on the income tax to raise revenue in an equitable manner."[23] Further, if other parameters and factors are included in optimal-tax model, the results and conclusions may change. Like, " when sources of progressivity - induced efficiency effects beyond labour supply are introduced in to the analysis - those associated with human capital effects, security as a public good, technological change, and the shadow economic, among other - the case for progressivity and a redistributive income tax may well not be weak one [24]." In the absence of more reliable guidance from empirical evidence, progressive income taxation needs no elaborate justification. But keeping in mind the incentive effect and tax evasion, marginal rates of income tax on individuals should be moderate.

2.2 An Ideal Income-tax System

An ideal income-tax system is one which adheres to the different principles enunciated in the preceeding pages and is progressive. But some principles conflict with each other, for example, the principle of equity and productivity. Principle of productivity (generating more revenue for the government) demands imposition of more taxes and covers more individuals, which violates the principle of equity. So, there should be a balance between the two. In developing countries like India, government has to rely upon taxes to increase its revenue, therefore, the government should spend in productive channels in such a way that the level of

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23. Pechman, Joseph (1990) from Robert H. Haveman, Optimal Taxation and Public Policy, in M.Ouigley and Ekgene Smolensky (eds.), Harvard University Press, Cambridge, 1994, P.255.
24. Ibid.

productivity in the economy is raised and the condition of the poor people is also improved. Then reducing inequalities of income and wealth, and generating more income in the economy are also conflicting principles. On the one hand, high level of progressive taxation is necessary for reducing inequalities of income and wealth. On the other hand, for generating more income through promotion of saving and inducement to investors to invest more, low taxation is desired. This conflicting problem is solved if the resources transferred from the people to the government are utilised for development of the country or benefit of the people through various welfare progressive programmes. Further, the principle of full employment and price stability are also contradictory in nature. "A decline in the general price level is incompatible with the maintenance of full employment.......... Some trade-off between the two objectives may be necessary, that is, society may have to accept some unemployment in order to avoid inflation[25]." Therefore, an ideal income tax system maintains a balance between different objectives conflicting each other.

An ideal income-tax system is that where the policy of progressive income taxation is also adopted. A very strong case for progressive income tax rates exists in terms of ability-to-pay and the corresponding sacrifice which taxation involves. As we have already explained, those at higher levels of income, with greater ability-to-pay taxes, would pay a higher share of their income in tax. Income is considered as the primary indicator of tax paying ability and progressive income-tax structures are generally advocated as the type which best serve the goal of equity in the distribution of tax burdens. Since, equal distribution of income is the main concern of most of the developing countries' governments also, it is desirable to have an income tax system that is progressive. Although this argument is based upon the assumption that marginal utility of income is subject to a reduction as income rises, here we don't have to believe in the measurability of utility or the possibility of interpersonal comparisons. Further, the criticism regarding diminishing marginal utility of income does not disprove the case for progressivity - nor does it make a case for regressive or proportional income taxation. To prove the principle of progressivity wrong, it will have to be proved that marginal utility of income rises or remains same with increase in income, which of-course cannot be done. Therefore, a progressive income tax is advocated on the basis of social justice and fairness which manifest itself in the form of taxing the people according to their ability to pay.

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25. Due, J.F., Government Finance, op.cit. P.268-69

Further, since low-income persons tend to allocate most of their incomes to the purchase of necessary goods, while high income persons spend a greater proportion of their incomes on non essential or luxury goods, a reasonable judgment may favour progressive income taxation.

Progressive income tax is a suitable weapon for mobilising the expending output which result from the process of economic development for further capital formation and economic development. Here, the opponents of progressive income tax system claim that it is only the rich that can save and therefore if they are taxed more heavily than the poor, the saving potential will be lost or reduced. However, the argument in favour of progressive income taxation is that, because it is only the rich from whose incomes savings can come, the state should collect these savings by imposing heavy tax on them. Otherwise, rich may increase their consumption of luxuries and thus productive resources of the society may go waste. Secondly, in the absence of progressive taxation, the richer will become more rich and inequalities would increase. This will result in concentration of economic power in few hands which may cause social and political unrest also.

Progressive income taxation is also preferred for its administrative convenience. In the case of proportional or regressive taxation, tax collecting machinery has to cast its net very wide, which not only causes undue harassment to small taxpayers but also result in high cost of tax collection.

Policy of progressive income taxation has been criticised on the ground that progressivity affects the will to work more and save more adversely because people would not work more if they are not able to enjoy the fruits of their labour(incentive effect) which will retard the process of capital formation and productivity in general. But the principle of progressivity cann't be proved wrong on this ground also. As far as saving and investment is concerned, we have already seen that the government can perform these functions more efficiently. Regarding incentives for hard work, we should always keep in mind that it will be more fruitful for the economy if poor people find the existence of appropriate economic incentives. Because rich will rather opt for more leisure beyond a certain level of income while poor go for harder work for comparatively long time and increase their consumption and try to increase productivity further on account of larger income availability.

The case of progressive income taxation is also stronger as it is practised by almost every country today in raising the major part of their taxes. Therefore, an ideal tax system for a country will be one which is based on above mentioned principles and is designed in the light of the national policy, ensures fairness or social justice, promotes savings and investments and is capable of efficient administration.

2.3 Significance of Income-tax on Individuals in India

The structure of income-tax on individuals (personal income tax)[26] in India is based upon the principle of progressivity and, therefore, adheres to the principles of equity in the distribution of tax burden and social justice. Concept of 'income' is properly defined in the Act. Tax laws are made very carefully and have been modified from time to time according to the need of the country and circumstances. Tax rates, with exemption limit and other concessions, are imposed keeping in mind the different objectives.

The significance of personal income tax in India can be judged in terms of its share in direct taxes. The contribution of direct taxes to the total tax receipts of the centre and the share of personal income tax in direct taxes have been shown in the following table.

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26. 'Individuals' account for more than 90 per cent of the total number of personal income tax payers and their taxable income.

Table 1

Share of personal Income Tax in Tax Revenue Receipts of the Central Government of India.
(1980 - 81 to 1995 - 96)

(Rs. in Crore)

Year	Tax Revenue Receipts from			(3)as Percentage of 4	(2)as Percentage of 3	(2)as %age of 4
	Personal Income Tax	Direct Taxes	Total			
1	2	3	4	5	6	7
1980-81	1,506	2907	13149	22.1	51.8	11.5
1985-86	2,509	5564	28631	19.4	45.1	8.8
1990-91	5,371	11024	57513	19.2	48.7	9.3
1991-92	6,724	15352	67266	22.8	43.8	9.9
1992-93	7,888	18132	74566	24.3	43.5	10.6
1993-94	9,115	20291	75619	26.8	44.9	12.1
1994-95*	11,000	25515	89831	28.4	43.1	12.2
1995-96**	13,500	30276	103762	29.2	44.6	13.0

Notes :

1. Figures of tax revenue are inclusive of taxes of Union Territories and States share in Union Taxes.
2. * figures in this year are as per the revised estimates ** figures in this year are per budget estimates.

Source: Various issues of the Report on CurrencyandFinance, RBI

The share of direct taxes in the Centre's gross tax revenue declined from 22.1 percent in 1980-81 to 19.2 percent in 1990-91. In 1950-51, direct taxes accounted for 36.8 percent of central tax collections. This decline in the relative share of direct taxes was mainly due to dwindling share of personal income tax in central taxes. Personal income tax accounted for 32.7 percent of central government taxes in 1950-51. However, its share declined over the years and was estimated to be 9.3 percent in 1990-91.

But the share of direct taxes in Centre's gross tax revenue has gone up impressively from barely 19.2 percent in 1990-91 to an estimated 29.2 percent in 1995-96 and the share of personal income tax, from 9.3 percent to 13 per cent in the same period. This improvement in the share of personal income tax as well as direct taxes, which are generally regarded a more equitable way of raising revenue, is the result of over all tax reforms since July 1991.

The significance of personal income tax can be proved from its impressive share in direct taxes. Personal income tax accounted for 51.8 percent of direct taxes in 1980-81. Though this share declined to 43.8 percent in 1991-92, it again rose to an estimated 44.6 percent (Table-1). Total number of individual assessees has also been increased from 5.1 million as on 31st March, 1989 and 5.3 million on 31st March, 1990 to 5.7 million on 31st March, 1991. 27 Therefore, personal income tax is an important direct tax.

Although personal income tax is a significant direct tax, a comparison of India with OECD (Organisation of Economic Cooperation and Development) member countries reveal that revenue from personal income tax constituted only 12 percent of total tax revenue of the Central Government in the year 1993-94, which is the lowest, except Greece, among all OECD member countries. This is clear from the following table :

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27. Report of the Comptroller and Auditor General of India, Union Government, No.5, 1992

Table 2

Personal Income Tax as a percentage of total tax receipts (1993-94)

Country	Personal Income Tax (in percentage)
Australia	40.9
Austria	21.6
Belgium	31.2
Canada	39.6
Denmark	53.6
Finland	40.2
France	13.8
Germany	28.0
Greece	10.2
Iceland	26.5
India	12.0
Ireland	32.0
Italy	27.2
Japan	25.3
Luxemburg	22.2
Mexico	-[1]
Netherlands	24.8
New Zealand	44.5
Norway	25.1
Portugal	20.4
Spain23.6	
Sweden	36.0
Switzerland	34.6
Turkey	27.9
United Kingdom	28.4
United States	34.3
OECD Average [2]	29.7

Notes : 1. ** Not available

2. Unweighted

Source: Revenue Statistics of OECD Member Countries, OECD, Paris, 1994.

The level of taxation in a country is traditionally judged in terms of the ratio of tax revenue to gross domestic product (GDP) at current market prices. Tax/GDP ratio reflects the degree of government control over disposition of purchasing power in an economy.[28] This ratio is also regarded as an index of relative tax burden on the society. In 1950-51, taxes formed 6.7 percent of GDP. Tax/GDP ratio became 11.2 percent in 1988-89 and decreased to 10.4 percent budgeted for 1996-97. [29]

Following table reveals the share of direct taxes and personal income tax in GDP. The share of direct taxes in GDP rose from 2.1 percent in 1980-81 to an estimated 2.9 percent in 1995-96. There has, no doubt, been an increase in the share of direct taxes in central taxes but their ratio to GDP still remains at only about 2.9 percent. The share of personal income tax in GDP rose only from 1.1 percent in 1980-81 to an estimated 1.3 percent in 1995-96.

Table - 3

Taxes on Personal Income as percentage of GDP at current prices in India

Year	GDP at Current Market Prices(Rs.Crore)	Direct Taxes	Personal Income Tax
1	2	3	4
1980-81	136013	2.1	1.1
1985-86	262243	2.1	0.4
1990-91	532030	2.1	1.0
1991-92	615655	2.4	1.1
1992-93	705566	2.6	1.1
1993-94 p	801032	2.5	1.1
1994-95 *	945615	2.7	1.2
1995-96 **	NA.	2.9	1.3

Notes:

1. * Figures in this year are as perthe Quick Estimates.
   ** Figures in this year as per budget estimates.
2. Provisional Estimates.

Source : Column (2) Various issues of The Report on Currency and Finance, RBI. For the year 1995-96 , Govt. of India, Ministry of Finance, Economic Survey (1995-96).

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28. Sury, M.M.: "Tax Structure Developments In India : 1950-90", Journal of Indian School of Political Economy, Jan-March 1991.
29. Monthly review of the Indian Economy, Centre for Monitoring Indian Economy Pvt. Ltd. July, 1996, P.128.

It is true that in developing countries, like India, Income tax raises less revenue as a percent of total Tax Revenue and gross domestic product as compared to high income nations, but this is the result of the peculiar circumstances of developing countries, which include large agriculture sector of subsistence nature, with lack of monetisation and accounting practices, small number of large-scale industries , presence of small firms and low levels of income. But, India's income tax to GDP ratio is still extremely low by the standards of both developed and developing countries [30]. Collection from income taxes formed about 1.2 percent of GDP during 1971-90 compared to 3.5 percent on average for countries with per capita income below $360.[31] Narrow tax base is the main reason behind it. First reason for the narrow tax base is that agriculture which constitutes a large proportion of the GDP, is outside the purview of the income tax, and secondly, because of the low level of per capita income a large number of income-earners do not come into the purview of income-tax, as the exemption limit of personal income tax with many other concessions are being provided to achieve the objective of equal distribution of income and social justice. Only 110 Lacs persons pay income tax in India[32]. In fact, the income-tax revenue from individuals depends upon four factors, namely, tax base, tax rates, efficiency of tax administration and tax compliance on the part of the individuals. Since maximum rate of income-tax on individuals is also being reduced and tax administration as well as tax compliance are capable of slow and gradual improvement in India, personal income tax constitues relatively small share of Central Government's total tax revenue. Tax evasion also reduced revenue from personal income tax, which is the result of less effective tax administration. Acharya and Associates (1985) estimated the amount of income escaping income tax at 243 percent of ascessed income during that year. Tax amnesties, declared by the government in different years, like 1965-66, 1975-76, 1980-81, 1985-86, 1991-92, etc., also reduce the share of income-tax in Central Governments total tax receipts to some extent. Because, " if amnesties are anticipated, they may lower compliance in preamnesty years as taxpayers engage in intertemporal substitution of their disclosures."[33] But in amnesty years and in postamnesty years government receipts may increase owing to the induced conversion of black assets in to white which increase the flow of white incomes.

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30. Relief All Round (editorial), The Times of India March 1, 1997, P. 12.
31. Government of India, he Tax Reform Committee(1991)
32. Finance Minister's Budget Speech, Union Budget, 1996-97.
33. Das-Gupta, Arindam; Lahiri, Radhika and Mookherjee, Dilip:"Income Tax Compliance in India - An Empirical Analysis," World Development, 23(12), 1995, PP.2055.

But, all these problems are the only obstacles in the path of effective individual income tax system, which do not question the importance of individual income tax and can be removed with the tool of tax - reforms. This has been proved by the impressive growth of the revenue from personal income tax after 1991 - the year of reforms. Tax reforms, based on the Tax Reform Committee's (1991) recommendations, have resulted in an increase of personal income tax revenue at the rate of 21 per cent per annum in the three years (1991-92 to 1993-94) making a jump of 3 percentage points over the growth recorded in the preceeding five years.[34] Tax reforms, in the form of simplicity, of the tax structure, moderate tax rates with a wider base and better enforcement can improve the share of personal income tax revenue in the total tax revenue of the Central Government. " Best practice enforcement, assessment and tax structure policies could have yielded at most a 90 % revenue increase, leaving India's income tax performance below the average of countries with similar GDP per capita".[35] Although, increasing trend in revenue from personal income tax with increase in gross domestic product at current market prices proves the elasticity of personal income taxation, increasing government control over disposition of purchasing power and increasing resource mobilisation as increased portion of gross domestic product is being placed in the hands of the government in the form of taxes, yet, the personal income tax system is not perfect in India and there is scope for betterment. Principles on which the system is based, are quite good but there are drawbacks in the implementation of taxation policy. Burden of personal income tax is not equal on all the individual tax payers.

After analysing the various principles and theories of income taxation and significance of personal income tax in India, now we review the evolution of income tax system in India.

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34. Bagchi Amaresh : Strengthening Direct Taxes Some Suggestions. Economic & Political Weekly, Vol.XXX No.7 & 8, Feb. 18-25, 1995 PP.380.
35. Das-Gupta, Arindam, and others, op. cit., PP 2051