RECENT INITIATIVES IN ENFORCEMENT AND TRENDS IN INCOME TAX REVENUES

An Appraisal

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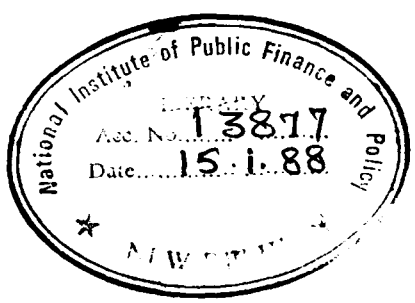

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An Appraisal

Much has been said about the buoyancy of income tax revenues in India in the last two years as conclusive evidence of the validity of the proposition that low tax rates bring in more revenue, providing yet another corroboration of the "Laffer curve" hypothesis. That a regime of reasonable rates is conducive to good growth of tax revenues can scarcely be questioned. That there has been a spurt in the revenue from income tax since 1985-86 is also undeniable. The point that is missed in the polemics that pour out from all sides in any public discussion on personal income tax is that what is reasonable in the case of tax rates is ultimately a matter of judgement. Evidence from the past does not lend much support for the belief that tax rate reduction by itself leads to better compliance and larger revenues.[1] On the contrary, after the maximum marginal rates of income tax were brought down drastically in successive steps beginning 1973-74, the elasticity of non-corporate income tax appears to have suffered a sharp decline.[2] However, the results may be quite different when vigorous enforcement is combined with lowering of rates of both income tax and wealth tax, as seems to have been the case with the recent initiatives in the tax field. Since the apparent success of the new strategy has been cited in support of the plea for further cuts in tax rates and the question of effective enforcement of income tax is important for the community's confidence in the fairness of the tax system, it is necessary to see objectively whether the new strategy has really paid off and can be depended upon for the future. For this purpose, one has to take a

close look at what has actually been achieved by the reforms in terms of revenue buoyancy, that is, examine whether the growth in the tax revenue that has actually taken place marks a distinct break with the past, before proceeding to look for the likely causes. This note is an attempt to study statistically whether the spurt in income tax revenues since 1985-86 can be regarded as significant and examine in that light the soundness of some of the components of the new strategy. Section II of the paper presents the results of the statistical exercise. In Section III we discuss some aspects of the recent enforcement measures in income tax in an attempt to identify their strength or weakness in securing better compliance. Section IV draws together the main conclusions.

II

Figures of revenue from non-corporate income tax since 1973-74 are given in Table 1 (Column 2). Column 3 of the Table gives the annual growth rates. It will be seen that in 1985-86, the year in which the current reforms were initiated, there was a big increase in revenue (over 30%). No doubt this is the biggest increase that has occurred in personal income tax revenue in recent years barring only 1975-76 when the revenue had registered a growth of about 39%.[3] The growth however tapered off in the two following years, namely, 1986-87 (R.E.) and 1987-88 (B.E.) to 10.2% and 2.9% respectively. Even assuming that the estimates for 1987-88 are on the conservative side and an increase of about Rs. 200 crore over the budget estimates can be easily expected (excluding the yield of the recently imposed surcharge), the growth in 1987-88 is unlikely to exceed 10%.[4] If allowance is made for the fact that the spurt that occurred in 1985-86 raised the base to a much higher level than would have obtained had past trends prevailed and that around Rs. 200 crore of the collections in 1985-86 may be attributed to the amnesty scheme that has also been in operation simultaneously, the growth in 1985-86

comes down to 20% while that for 1986-87 goes up to 20%. Taking the three-year period 1985-86 to 1987-88 as a whole, the compound growth rate in revenue (without any adjustment for the amnesty yield) works out to nearly 14% per annum as compared with a compound growth rate of only 7.5% in the previous five years and 10.2% in the six years preceding that. On the face of it this is an impressive achievement.

However, the last two years have also seen the operation of an amnesty scheme and it may not be unreasonable to suppose that at least a part of the increase in revenue in this period is the product of amnesty. Whether there has been a change in the underlying trend, because of the measures taken in these two years, is not easy to figure out until some more years go by. Moreover, other things given, growth in income tax revenue depends primarily on growth in money incomes. Hence, any assessment of the trends in revenue from income tax has to be made with reference to the growth in incomes in current prices. This is why the standard method of testing whether a given income tax system is efficient in terms of built-in capacity to produce revenue commensurate with growth in incomes is to go by its elasticity.

In a progressive system of income taxation, the elasticity of income tax with respect to income should normally exceed unity. Given unchanged income distribution and the likelihood of greater degree of evasion in the upper income ranges any improvement in the revenue-yielding efficiency of the tax system in a given period because of special administrative measures or reform of the structure should be reflected at least partly in the elasticity measure for the period in question as compared with that observed in the immediately preceding period. However, three years is too short a period to provide a good test of elasticity change.

One way of judging in the interim whether there has been a break with the past trends is to project the growth in revenue on the

basis of the elasticity of tax revenue with respect to GDP observed in the recent past, and the actual (or anticipated) GDP growth for the years in question and see if the deviations of the (actual) figures of revenue from the figures so projected are statistically significant.

In comparing the actual collections with projections based on elasticity it is necessary to "clean" the actuals to eliminate the effects of "discretionary" changes made from year to year as otherwise the improvement in the elasticity that may have taken place may be clouded by changes in the tax structure having a large impact on revenue (e.g., enhancement of the exemption limit). Figures of actual collections of non-corporate income tax, the cleaned series (the cleaning done by following the well-known Prest method of "proportional adjustment"), and forecasts based on the elasticity equation are given in Table 2. The elasticity estimate is based on data for the years 1973-74 to 1984-85. The deviations of the cleaned figures of actual collections for the three years, viz., 1985-86, 1986-87 and 1987-88 (budget estimates for 1987-88) were tested for significance and none of the deviations was found significant at the 5% level.

Table 2 also gives the forecasts based on buoyancy (Column 2). The buoyancy forecasts give projections based on the relationship observed between actual revenue (i.e., without any cleaning or adjustment for the impact of discretionary changes made from year to year) and GDP growth. Deviations of the actuals from these forecasts for the three years are not significant either (at the 5% level).

These results should not however be taken to imply that the recent reforms have made no difference at all to the situation. Subject to the limitations associated with such exercises, they only serve to point out that the growth in revenue noticed in the last three years, however big they may appear at first sight, do not yet indicate a statistically significant break from the past trends. The

deviations observed in the actuals from the projections based on the trends may well have been due purely to "random" factors and do not provide evidence to predict with any degree of confidence that these will be sustained in the future. In other words, there is no evidence yet to warrant any conclusion that compliance has improved as compared with the past to such an extent as to bring about an appreciable and lasting improvement in the growth of income tax revenues. Definitive judgements on the success of the new policy are better suspended until the trend is observed for a longer period and perhaps some rethinking is needed about certain aspects of the new strategy if the tempo of rising collections is to be maintained. The further fact that a part of the increase in 1985-86 and 1986-87 is attributable to the amnesty and, going by the trends for 1987-88, the growth seems to be tapering off, lends support to this prognostication. Despite its apparent success, the new strategy may have certain gaps or weaknesses and needs strengthening or reconsideration.

III

The reasoning on which the new strategy is premised is that a reasonable tax structure (moderate rates and simple laws and procedures) combined with vigorous enforcement should produce results by inducing better compliance. The underlying logic - derived essentially from the "economics of crime methodology" developed by Gary Becker[5] - is simple, viz., that if cost of evasion can be raised relatively to the cost of compliance, no one would find it profitable to evade. Since cost of evasion is the product of penalties prescribed for evasion and the probability of detection, other things remaining the same, actions which facilitate detection should help to raise the cost of evasion. The cost of compliance on the other hand gets reduced when the tax rates are brought down and the laws and procedures simplified. The changes in laws and administrative

initiatives seen in the last three years do bear the imprint of this reasoning. In order to reduce the costs of compliance the rates have been reduced both for income tax and wealth tax and liberal terms were offered for disclosure of earlier concealments. A major effort has been put in to simplify the laws and procedures for income tax drastically.[6] Simultaneously a drive was mounted to detect and penalise evaders and thereby raise the cost of evasion.

Apart from administrative steps and rate reduction, notable measures purporting to raise the cost of evasion and bring down that of compliance are:

- prosecution of tax evaders to put them behind the bars rather than subjecting them to civil penalty and removal of impediments to successful prosecution, e.g., by shifting the onus of mens rea, that is, proving the guilty intent which normally lies with the prosecution in the case of criminal offences, to the taxpayer who will now be required to establish his innocence;

- proposal to levy an additional tax of 30% on any difference between the income returned and the income finally assessed instead of any civil penalty as such;

- provision empowering the government to pre-empt the purchase of immovable properties undergoing a sale or transfer at the value declared in the deed of conveyance almost at random;

- intensification of raids; and

- introduction of self-assessment scheme based on automatic acceptance of all income tax returns and scrutiny of a few returns selected on random sampling.

The intention underlying the measures noted above is unexceptionable and on the face of it some of these should be of help in countering evasion and securing better compliance with tax laws. A closer look would however show that they are not all consistent or based on sound logic and may in fact have the effect of weakening the compulsions for tax compliance. The reasons for this pessimism are indicated briefly below.

a. Reliance on Prosecution to Deter Evasion and Removal of Civil Penalty

A serious impediment to effective enforcement of taxes in India, it is often alleged by tax enforcement agencies, is the reluctance of the courts to grant conviction in the case of tax frauds. Even the levy of civil penalties is said to be difficult to sustain because of the courts' insistence on proving the mens rea - the guilty intent - on the part of the taxpayer. In any criminal proceedings the onus of proof lies normally with the prosecution, that is, the tax authorities and since tax crimes are investigated long after they are committed, the task of proving the guilty intent is no doubt formidable in most cases. To get over this difficulty, the onus of proving the mens rea has been shifted by an amendment in the law carried out in 1986. It is now for the taxpayer charged with misdemeanour in compliance with tax laws to prove his innocence. This, it is hoped, will make it possible to secure prison sentences for tax offences and instil the necessary fear among intending evaders, in other words, will raise the cost of evasion.

While it is true that standards of evidence required for proving a criminal offence are exacting - and that is quite in the fitness of things in a democratic society - it would be unrealistic to think that prosecution for tax offences can be very much easier with the mere shifting of mens rea onus.

Given our legal framework, prosecution for criminal offence is in all circumstances bound to be much more difficult than imposition of penalty and the standard of evidence required will be more exacting. Even with the shifting of the onus of mens rea, it is doubtful if courts in India will grant conviction with harsh sentences unless culpable guilt is proved beyond all reasonable doubt and it would be unrealistic to presume that the prosecution route will prove easier simply because of the onus shifting. It may be recalled that, when the penalties were raised to 200% of the income concealed, judicial authorities hesitated to uphold imposition of penalty even in cases where the guilt was well established and the change made in the law to facilitate this action remained virtually inoperative. For the same reason, it is doubtful if the threat of pre-emptive acquisition of property at random is likely to be effective. The measure though well intentioned and apparently reasonable confers powers on the government which can be used arbitrarily and may well be regarded as repugnant to our constitutional framework. Whether it is sustained by the courts remains to be seen.

It would thus be futile to hope that prosecutions will be easier and so the cost of evasion will go up because of shifting of mens rea or the threat of pre-emptive property acquisition. On the contrary, the cost of concealment will go down with the removal of civil penalty as has been proposed now.

Under one of the green paper proposals of last year which have just been enacted into law by Parliament, there will be no distinction between evasion and honest difference of opinion, at least in matters of civil penalty. There will hereafter be only levy of an additional tax of 30% on any difference between assessed income and the figure returned by the taxpayer. While it might make the task of the tax officer simple - as there would be no need for him to establish the case for the additions made to income returned by the assessee and prove the guilty intent by the exacting standards laid down by courts for sustaining a penalty for tax fraud - the effect

will be to take the sting off the penalty for evasion as the additional tax will apply equally in all cases of divergence between assessed income and the income returned irrespective of whether the understatement is wilful or not. As a result, penalty for concealment will get reduced from a maximum of 200% of the tax evaded to 30% of the income added in the process of scrutiny. For an evader in the top income bracket the total of tax and penalty for concealment will thus get reduced from 150% of income to only 80%. Hence, while stipulating a stake on the part of all assessees in returning the correct income as a necessary adjunct of the automatic acceptance of income tax returns, the amendment will have the effect of lightening the penalty attendant on deliberate concealment on detection, while those who disclose their receipts truly but claim relief or deductions in honest belief about their admissibility will be penalised on the same footing as wilful dodgers. This cannot but cast doubt on the fairness of the entire system which is essential for enjoining respect for any law. Coming close on the heels of reduction in tax rates this measure which has been proposed to get round the problem of proving concealment will clearly have the effect of reducing the cost of evasion quite drastically.

This prognostication may be questioned on the reasoning put forward by some (e.g., Virmani)[7] that where there is a high degree of corruption in the tax administration, raising the penalty levels may in fact reduce compliance and therefore revenues and merely result in larger gains for corrupt tax officials. The model on which this reasoning is based overlooks the fact that, first, higher penalty means higher cost of evasion, and to what extent this is neutralised by the corruption factor is an empirical question. Secondly, if, as is argued by proponents of this view that there is a "critical marginal reward level" for tax officers, they should all turn corrupt, unless their remuneration exceeded that level. If this logic prevailed, given the relatively low level of emoluments of public servants, there cannot be a single honest tax official in this country! Mercifully, this is not yet the case in India. There are

many public servants in India even in tax departments whose integrity is not a marketable commodity. Hence, while the corruption factor does complicate the picture, to assert that raising the level of penalty for evasion might result in less compliance (and conversely, lowering the penalties might improve compliance) rests on an extremely dim view of the tax bureaucracy. Besides, the standard of honesty in administration is a function of, inter alia, the contingent threat of being detected and sacked. If this threat is made more effective than before, there is no reason to assume that raising penalty levels will reduce compliance. Unless one assumes that the tax administration is totally and incurably corrupt, the policy of concentrating on prosecution to the exclusion of civil penalty would seem to be misconceived and risky especially with the poor experience so far in getting any one finally sentenced to even a moderate prison term for a tax offence in India. Hence, while going all out for prosecution, it would have been prudent not to dispense with civil penalty.

In any case, there is a contradiction in the logic in reducing (rather, virtually removing) civil penalties for evasion on the ground that obtaining the court's satisfaction in proving tax offences is beyond the capacity of the tax administration while turning to the prosecution route for fighting evasion on the supposition that this may be easier now. If shifting of mens rea could pave the way for prosecution, by the same token, it should have facilitated levy of civil penalty as well and, for tax crimes, civil penalties may appear more reasonable to judicial authorities than prison setences. On considerations of practicality and also of coherence with our legal framework, it would have been advisable to rely more on civil penalty than on prosecution for punishing evaders especially after the mens rea onus was shifted to the taxpayer.[8] For, on the whole, the combined effect of the reduction in rates and removal of civil penalties will be a reduction in the cost of evasion.

b. Accent on Raids

Another factor which seems to have thwarted attempts to bring tax evaders to book is lack of adequate documentary evidence. With the practice of maintaining a duplicate ("No.2") set of documents, tax dodgers can get around all attempts to nab them in a straightforward fashion and the only way to fix them, it is commonly argued by most tax enforcing agencies, is to carry out surprise raids whenever there is some reliable intelligence report regarding concealment of documents and/or assets by taxpayers. On this view, there is no better way of detecting evasion and getting hold of clinching evidence than a thorough search of the business and residential premises and seizure of incriminating documents and assets.

Successful detection is unquestionably a prerequisite for success in securing conviction. The offensive mounted against evaders through raids in recent years is obviously an effort towards detection. It should be recognised however that a "raid" is only an aid or a means to detection and, contrary to the impression often sought to be created, a raid does not constitute detection in itself. If it is to lead to successful prosecution, a raid should be able to bring out material which can prove the alleged tax offence to the hilt. Quite erroneously, there is a tendency to treat a raid as a punishment, a conviction in itself. Given the way authority is exercised in our country, this may be true and it is arguable that raids may have a deterrent effect even if they do not lead to convictions as they impose costs on taxpayers and these costs will be higher for evaders than for non-evaders.[9] But unless punishment is imposed through due process of law, a raid cannot be equated with conviction and cannot produce the same deterrent effect. On the contrary, it the proportion of success in obtaining conviction in raid cases is not sufficiently high, raids may lose their potency and in fact may come to be looked upon as an instrument of harassment and political vendetta.

Information regarding the proportion of convictions in tax cases arising out of raids in the recent past is not available. However, there is reason to think that not all raids, not even a large proportion of them, end up in a conviction of the alleged evader. Claims of seizures of unaccounted cash, jewellery and "incriminating" documents usually made in the wake of raids are not all substantiated in subsequent proceedings. If this impression happens to be correct, as it probably is, indiscriminate raids such as those undertaken for an entire class of taxpayers can be counter-productive. For such raids make martyrs of their victims or, if they are really innocent, turn them into diehard evaders.

c. Inadequate Attention to Information System Development

No matter on whose side the onus of mens rea lies, what is important in booking a tax fraud successfully is to produce clinching evidence and that requires patient collation of information. While it is very useful in some cases, a raid may not be the only or best way of collecting such information. If raids were that potent in curbing evasion, with large-scale raids since the mid-Sixties when amendments were made in the law to widen the powers of search and seizure by income tax authorities, evasion should have become negligible in this country by now (though it must be said that the impact of raids on compliance remains to be adequately studied). The fact is that it is only when information regarding financial transactions is collected from third parties and matched systematically that the message goes home that revenue authorities will surely, sooner or later, catch up if any relevant information is withheld. Then only does the probability of detection go up and evasion become really risky. It is not often realised that salary incomes are not usually evaded not so much because salary earners are more honest but because the system of flow of information regarding salary payments is fairly well established and also because the withholding system operates smoothly without much problem. In other words, opportunity of

evasion is less than in the case of other incomes. Hence, while retaining the powers of search and seizure, and resorting to "raids" as a weapon to be used when other means fail, the attempt should be to establish an efficient information system whereby third party reports of not only salaries but all items of income like interest, rent, commission, dividend, as also sale and purchase of assets and tradeable commodities are received and matched routinely in the income tax office. In tax enforcement that system works best which minimises the contact between taxpayers and tax gatherers. Hence the focus of the strategy of tax enforcement should be on extending the coverage and efficacy of third party reporting and the system of tax withholding.

It may be of interest to note that in USA use of raids or search warrant procedures is relatively rare and the number of raids carried out in a year is less than 100. It is the efficiency of the system of scrutiny ("audit") and, more than that, of the information system to collate and match third party reports to taxpayer returns which make the probability of detection high and helps to keep non-compliance in check. It is also relevant to note that in USA written notices are processed and raised on the basis of matching of third party reports to tax returns without undertaking any audit.

Of late, the emphasis in the strategy for tax enforcement in USA has been more on raising the probability of detection by imposing new requirements for information reporting by third parties and penalties for failure to file such reports rather than on raising the severity of prison sentences and so on (though convictions for tax fraud are probably much larger in USA than in many countries). This is in recognition of the fact that there are limits beyond which punishments for tax frauds cannot be expected to be raised in a democratic society. Death penalty or life imprisonment cannot possibly be considered to be within the feasible sets of punishment for evasion.[10] Hence the stress on strengthening the information system to produce the deterrent effect. In India, on the other hand,

there is a tendency on the part of every government to concentrate on "raids" and the number of raids carried out is kept up to demonstrate the intent to fight evasion, while the most important element in a strategy of tax enforcement, viz., building up of an efficient enforcement system gets low priority.

It must be said that as an aid to enforcement and information gathering the proposals in the Budget for 1987-88 to extend the withholding system were a step in the right direction and the exemption from the requirement of withholding granted in recent years for "small investors" etc. has been wrong. However, the operation of withholding and the information reporting system can have its desired effect only if the information is made use of and that requires revamping the entire system of working and record keeping in the Income Tax Department. Information matching in India should present no formidable difficulty, since the items of information would be fewer than in a country like the USA and the needed computer technology is not sophisticated.[11] Presumably, the Department has a scheme of computerising the system of information storage and scrutiny of returns by checking against information so stored up. There is no indication so far that the scheme has been operational or when it is going to be operational.

d. Too Liberal Self-Assessment Scheme

While, on the other hand, for reasons mentioned above, the cost of evasion may have declined despite the raids, one notices certain moves which may have the effect of reducing the probability of detection. Take, for instance, the scheme of "self-assessment" and the move to make assessments automatic in order to induce "voluntary compliance". The way the new system is being operated - it appears tax officers cannot question any return even when the income is palpably understated unless the case comes up in its turn for "scrutiny" - cannot but have the effect of lowering the probability of detection as perceived by taxpayers.

It would be futile to hope that the threat of random scrutiny will be adequate to provide the necessary deterrent effect. Scrutiny can be fruitful only if done on a carefully designed, stratified sample, and with a high degree of thoroughness. The belief which seems to have gained ground that random scrutiny will be enough and that a lower proportion of cases below Rs 1 lakh need be taken up for scrutiny is fallacious and may in fact produce the contrary effect.[12] This seems to be borne out by the revelation that several groups of assessees like contractors continue to disclose palpably low figures of profits on their gross receipts even after these were enhanced for the years for which "scrutiny" was undertaken and the enhancement was accepted by the assessee. As pointed out earlier, even in USA where the system relies so much on self-assessment, enhancements are made on the basis of information available with the IRS without going through the formalities of scrutiny and reopening. This obviously is being ruled out here in the name of "self-assessment". It is surprising that even company cases are being brought under the automatic assessment scheme.

Thus while raids may to some extent help to raise the probability of detection, the excessively liberal system of automatic assessment might weaken it. As stressed by Prof Richard Bird in his lecture in the course of his recent visit to India, there is no such thing as "voluntary compliance". Taxpayers comply only if they feel that non-compliance can entail serious consequences and that the chances of giving the slip to the tax authorities are slim. That feeling is yet to be instilled among taxpayers in India and is unlikely to get round, and hence tax compliance in India is unlikely to make a truly big leap until the information system in the Income Tax Department makes a "quantum jump".

e. Open-Ended Amnesties

The feeling that one can get away with evasion is strengthened by the extensions of amnesty given over the last two years. It is generally acknowledged that a tax amnesty can work only if it is held out for a short period and is preceded by a spell of hot chase by the tax authorities. The amnesty given in income tax in India in the last two financial years went along with the raids, so to say, and was repeatedly extended. This could scarcely have carried the conviction that the government meant business. While the strategy may have yielded some gain in revenue, the ambivalence reflected in the extensions, the assurances that no questions could be raised about source or about past records if larger incomes were declared and subsequently, the issue of bearer bonds like the Indira Vikas Patra was not exactly helpful in putting across the fear of God in our tax evaders. Measures like these did not quite go well with the welcome signs of determination to clean up the tax administration and be tough with the mighty among the tax dodgers.

f. "Precommitment" on the Part of Tax Authorities to a Sub-optimal Strategy

A further weakness of the new strategy is an inadequate appreciation of the fact that what induces compliance in a given environment is an extremely complex question. The proposition that the evil of black money would disappear if the tax rates were lowered has long known to be a myth among serious thinkers.[13] The fact noted earlier that successive reductions in the income tax rates in India beginning 1973-74 did not improve compliance is evidence enough to dispel any such illusion. That the recent tax cuts despite vigorous enforcement are yet to produce significant results again demonstrates that securing taxpayer compliance is not simple.

Indeed, there is a growing body of opinion that the revenue collection process partakes of the character of a "game", with observed levels of non-compliance, scrutiny and additional demands of tax and penalty raised determined by the interaction between tax-payers and the revenue authorities. The strategies to be adopted by the revenue authorities are therefore best worked out within the framework of a game theory.[14] The game theoretic approach models individual behaviour essentially in the same way as Becker does but extends the Becker methodology by treating government decisions on tax rates, penalty and selection of cases for scrutiny as endogenous. In such a framework, a precommitment may be useful in maximising the gains to the party making such precommitment. The assurance of stability in the tax structure and so on given by the government might thus appear to be justified. However, for the precommitment to be paying, the strategy to which commitment is made should be optimal and the precommitment should be credible. This is scarcely the case with the strategy being followed in India. When amnesties are extended, credibility suffers. Similarly, the assurance of automatic acceptance of return and no scrutiny unless the case comes up on random sample can scarcely be called an optimal strategy. Such precommitments tend to be counter-productive.

A further complicating factor is that tax compliance is influenced by many non-economic factors as well, such as cultural attitudes and so on, otherwise it would be difficult to explain why even with low probability of detection and low penalties any one should ever comply. What would be the best strategy for revenue authorities in a game theoretic framework and in a given social and political environment is a challenging area for research. The strategy of tax authorities aiming at raising the costs of dodging while reducing those of compliance are not altogether unsound. But policy makers should take into account the various constraints in which they have to operate in raising the cost of evasion and/or reducing the cost of compliance and see how far they can be overcome

instead of rushing with measures of doubtful efficacy and uncertain result.

IV

To sum up, the strategy of enforcement embodied in the recent initiatives in the field of income tax is yet to show convincing results. There is no evidence yet that the spurt in revenues noticed in 1985-86 and 1986-87 makes a definite break with the past trends. There is reason to think that the new strategy is seriously flawed in several respects and unless corrected in time might weaken the urges for compliance by taxpayers.

The most serious flaw lies in the reliance on prosecutions as the prime deterrent to tax crime virtually in place of civil penalty. It is unlikely that courts will countenance harsh prison sentences for tax offences more readily than before simply because of a shift in the initial burden of proof in regard to the guilty intent. Mens rea onus shifting would have proved more helpful in the matter of imposing civil penalty. Dispensing with civil penalty altogether may prove a costly mistake.

Secondly, the preoccupation with raids to the virtual relegation of other elements of enforcement strategy is unwise. Raids carry an air of drama but achieve no permanent result if undertaken indiscriminately. For a really deterrent enforcement strategy the most potent instrument is an efficient information system. An efficient system of information in a tax department calls for third party reporting of financial transactions and tax withholding. Even though a large segment of the Indian economy still remains outside the organised sector, there are interconnections between the organised and the unorganised sectors at several points. The statutory requirement that all payments in business exceeding a

specified limit must be by cheque or draft should strengthen such connections. Hence a good system of third party reporting should be able to capture the incomes originating in the unorganised sector on a much larger scale than at present. Collation of information in a computerised system is impersonal and avoids the risk of corruption and manipulation. No permanent improvement in tax compliance can come about until a comprehensive reporting and withholding system comes into operation and use is made of the information so gathered. This requires a radical transformation of the information system with close collaboration and exchange of information between authorities administering different taxes on the one hand and a thorough overhaul of record keeping in the tax departments as well as reorientation of basic attitudes of tax officers on the other.

Thirdly, the system of automatic assessment and selective scrutiny needs to be redesigned. While it may not be possible to scrutinise all tax returns, it is injudicious to extend prior commitment of acceptance of return in all cases irrespective of their nature. Scrutiny of cases taken up selectively has to be more thorough than is possible with the stress on disposals and so on.

Lastly, the tendency to placate evaders with amnesties on grounds of "practicality" is grievous for taxpayer as well as tax enforcement morale. Compromising with evaders should be the last option for any respectable government. Unless taxpayers are convinced that evasion will not pay, no amount of softness or rate reduction is going to help. The tapering off of the revenue from personal income tax this year is a clear pointer to the futility of expecting better compliance merely because of a lowering of tax rates and calls for some serious introspection regarding the soundness of some of the components of the new strategy.

NOTES AND REFERENCES

The Author is indebted to J V M Sarma and A K Halen for help in statistical analysis and to Arindam Das-Gupta and Louis L. Wilde for very useful comments and suggestions.

1. Amaresh Bagchi & M Govinda Rao, "Elasticity of Non-corporate Income Tax in India", Economic & Political Weekly, September 4, 1982.

2. The elasticity of non-corporate income tax with respect to GDP was 0.99 for the period 1965-66 to 1973-74 and 0.54 for 1974-75 to 1983-84. It may be argued that the impact of policy changes like tax rate reduction should be relfected primarily through changes in the constant term of the elasticity equation, and elasticity should remain unaltered, given unchanged progressivity. If, however, better compliance shows up in disclosure of relatively larger incomes in the upper income brackets, then the elasticity of the tax revenue should increase. In any case, from all account, income tax revenue growth suffered a steep decline in the first half of the 1980s even though the tax rates were brought down substantially during this period as compared to the past.

3. A sizeable part of the increase which took place in 1975-76 (about Rs 200 crore) was on account of the disclosure scheme of 1975. A scheme of amnesty with an effective rate of 50 per cent or even less (where income is split and shown in more than one name) was in operation in the last two years. How much of the increase noticed in 1985-86 can be attributed to the amnesties is not known. Hence for comparison no adjustment in the collections of 1975-76 is made here.

4. Collections reported in the first seven months of 1987-88 show a growth of about 11 per cent in personal income tax including the surcharge.

5. Gary S Becker, "Crime & Punishment: An Economic Approach", Journal of Political Economy, March-April 1968.

6. Vide Government of India, Ministry of Finance, Discussion Paper on Direct Taxes (August 1986).

7. Arvind Virmani, "Tax Evasion, Corruption and Administration: Monitoring the People's Agents Under Symmetric Dishonesty", Provisional Papers in Public Economics, World Bank, May 1987. For a variant of this model, see Jennifer F. Reinganum and Louis L. Wilde, "Expert Opinions as Insulation from Penalties for Non-Compliance", unpublished draft (California Institute of Technology, March 1986).

8. For cogent arguments in favour of this contention and a critique of the recent change in the tax laws relating to mens rea, see Alka Bajaj, "Mens Rea and Onus of Proof of Mens Rea Under Income Tax Act, 1961" (Working Paper No. 24, National Institute of Public Finance and Policy).

9. This was pointed out by Wilde in his comments on the draft of this paper. It is, however, not obvious that the cost will be less for non-evaders if they also have to go through the same process of assessment, appeals, etc. to establish their innocence whereas evaders who are resourceful can take all that in their stride.

10. Michael J. Graetz and Louis L. Wilde, "The Economics of Tax Compliance : Fact & Fantasy", National Tax Journal, September 1985.

11. This point also was made by Wilde in his comments.

12. A. Das-Gupta, "Principles for Random Scrutiny of Income Tax Returns", Economic & Political Weekly, February 7, 1987.

13. See Graetz & Wilde, op. cit.

14. Ibid.

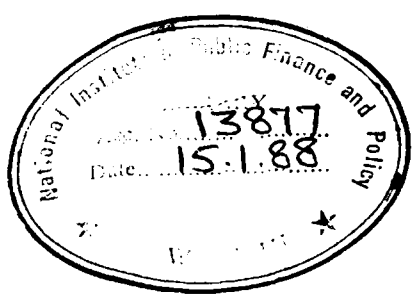

TABLE 1

Growth of Revenue from Non-Corporate Income Tax

(Rs crore)

Year	Revenue	Annual Growth (%)
1973-74	745.16	-
1974-75	874.41	17.3
1975-76	1214.36	39.9
1976-77	1194.39	(-)1.6
1977-78	1002.02	(-)16.1
1978-79	1177.39	17.5
1979-80	1340.31	13.8
1980-81	1440.00	27.5
1981-82	1474.50	2.5
1982-83	1569.72	6.4
1983-84	1699.14	8.2
1984-85	1927.16	13.4
1985-86	2509.00	30.2
1986-87 (R.E)	2764.00	10.2
1987-88 (R.E)	2845.00	2.9

Source: Budget documents of the Government of India.

TABLE 2

Forecast of Non-Corporate Income Tax

(Rs crore)

Year	Buoyancy equation forecast	Cleaned series	Elasticity equation forecast
1973-74	865.01	745.16	850.49
1974-75	957.50	874.41	950.19
1975-76	996.18	1223.36	989.45
1976-77	1043.36	1203.23	1037.38
1977-78	1118.30	986.07	1113.59
1978-79	1177.35	1163.77	1173.72
1979-80	1241.33	1276.27	1245.07
1980-81	1384.80	1371.20	1385.49
1981-82	1512.85	1514.51	1516.57
1982-83	1619.19	1672.04	1625.61
1983-84	1789.49	1735.76	1800.55
1984-85	1901.67	1892.08	1916.01
1985-86	2055.78	2656.74	2074.86
1986-87 (R.E)	2194.63	2918.28	2218.20
1987-88 (R.E)	2342.86	3003.80	2371.45

Notes:

1. The elasticity and buoyancy co-efficients for the period 1973-74 to 1984-85 are:

   e = 0.62399
   b = 0.61050

   The relevant regression equations are:

   log T = log 0.10175 + 0.62399 log Y (i)
   log T = log 0.05633 + 0.61050 log Y (ii)

   where (i) gives the elasticity equation and (ii) the buoyancy equation.

   T stands for tax revenue and Y for GDP .

2. The figures for GNP are projected for 1986-87 and 1987-88 by assuming 6 % increase in prices and 5 % in real income over 1985-86.

3. The forecasts for 1985-86, 1986-87 and 1987-88 are based on the figures of e and b and applying them in the equations given above.

TABLE 3

Forecast of Income and Corporation Tax

(Rs crore)

Year	Actual collection	Cleaned series	Elasticity equation forecast	Buoyancy equation forecast
1973-74	1327.76	1327.76	1504.86	1510.52
1974-75	1583.89	1583.89	1728.10	1747.38
1975-76	2076.06	2074.56	1823.85	1849.50
1976-77	2178.61	2177.04	1942.47	1976.39
1977-78	2222.79	2142.84	2134.88	2183.09
1978-79	2428.86	2325.40	2289.81	2350.24
1979-80	2732.21	2564.51	2477.09	2553.12
1980-81	2817.18	2581.95	2856.08	2966.09
1981-82	3445.47	3341.93	3221.61	3367.17
1982-83	3754.23	2698.88	3533.82	3711.69
1983-84	4191.87	3982.68	4049.32	4284.01
1984-85	4483.06	4188.08	4398.86	4674.33
1985-86	5365.08	4961.62	4890.88	5226.79
1986-87	6094.00	5616.30	5346.11	5740.36
1987-88	6382.00	5881.72	5843.71	6304.40

Notes

1. Period (1973-74 to 1984-85)
   e = 0.87546
   b = 0.83129

2. Figure of GNP assumed, same as for 1.

3. log T = -2.29685 + 0.87546 log Y
   log T = -1.81543 + 0.83129 log Y

   Notations as in Table 2.