



THE RELATIONSHIP BETWEEN PERSONAL INCOME TAX AND ECONOMIC INEQUALITY IN INDIA

DR. MUDDAGANGAIAH K.C

ASSOCIATE PROFESSOR

DEPT. OF COMMERCE AND MANAGEMENT

GOVT. FIRST GRADE COLLEGE, TUMKUR

Abstract

This paper explores the intricate relationship between personal income tax (PIT) and economic inequality in India. Using theoretical perspectives, empirical evidence, and comparative analysis, it examines how tax structures, compliance behavior, and redistributive fiscal policies affect income distribution. The study finds that while India's personal income tax system is progressive in design, its limited reach, high evasion rates, and reliance on indirect taxes significantly constrain its redistributive potential. The paper also presents statistical tables and visual analyses to illustrate income inequality trends and tax collection patterns. Finally, it outlines policy recommendations for achieving a fairer and more effective taxation framework.

1. Introduction

Economic inequality has emerged as one of the most pressing socio-economic challenges of the 21st century, particularly in developing countries like India. Despite experiencing remarkable economic growth since liberalization in 1991, India continues to face deep structural disparities in income and wealth distribution. The top 10% of the population commands over 60% of the national income, while the bottom 50% accounts for less than 15%, according to the *World Inequality Database (2023)*. This uneven distribution highlights a widening gap between the rich and the poor, undermining the principles of inclusive growth and social justice envisioned in the Indian Constitution.



Fiscal policy, especially taxation, plays a critical role in mitigating inequality by redistributing income and funding public welfare programs. Among various fiscal tools, **personal income tax (PIT)** is one of the most direct and equitable mechanisms available to governments for addressing income inequality. Unlike indirect taxes such as Goods and Services Tax (GST) or excise duties, which are regressive in nature, personal income tax is **progressive**—it places a higher burden on those with greater capacity to pay. The underlying logic is that individuals with higher incomes should contribute a proportionally larger share of their earnings toward national development, thereby helping to reduce income disparities.

In India, the personal income tax system has evolved significantly since its introduction in 1860 under British rule. The Income Tax Act of 1961 established the legal foundation for direct taxation, and successive reforms have sought to enhance compliance, simplify procedures, and broaden the tax base. However, despite these efforts, India's tax-to-GDP ratio remains one of the lowest among major economies—hovering around 11–12%, compared to over 30% in OECD countries. This discrepancy is largely attributed to widespread tax evasion, a narrow tax base, and a high reliance on indirect taxation. Only about **6–7% of India's population** files income tax returns, which means a vast portion of potential taxpayers—especially among high-income professionals and informal sector participants—remains outside the direct tax net.

The relationship between personal income tax and economic inequality is multidimensional. On one hand, a progressive PIT system should, in theory, reduce inequality by redistributing income through higher taxation of the wealthy and subsequent social spending on health, education, and poverty alleviation. On the other hand, if tax compliance is low, enforcement is weak, and loopholes are rampant, the redistributive potential of personal income tax diminishes sharply. This leads to a paradoxical situation: even as India maintains a formally progressive tax structure, the **effective tax incidence** often turns regressive due to exemptions, deductions, and underreporting.

Furthermore, India's tax policy framework must be viewed within the broader context of its **dual economy**—a modern formal sector coexisting with a vast informal economy. The informal



sector, which employs more than 80% of the workforce, largely escapes direct taxation. This results in an uneven fiscal burden where lower- and middle-income groups indirectly shoulder a greater share through consumption-based taxes. Consequently, while the rich benefit from tax planning opportunities, the poor contribute more relative to their income—a phenomenon that exacerbates inequality.

Another critical dimension of this issue lies in the **allocation of tax revenue**. Even when personal income tax collections increase, their impact on inequality depends on how the revenue is utilized. If the government channels funds toward welfare programs, education, healthcare, and infrastructure for marginalized populations, the redistributive effect is positive. Conversely, if tax revenue primarily finances subsidies for higher-income groups or non-productive expenditures, the potential for inequality reduction remains limited.

The evolution of personal income taxation in India also reflects changing economic philosophies. The pre-liberalization era emphasized high marginal tax rates as a means of social equity, often exceeding 90%. However, this approach led to large-scale evasion and the growth of a parallel “black economy.” Post-liberalization reforms in the 1990s shifted the focus toward **lower rates and higher compliance**, based on the assumption that moderate taxation encourages voluntary participation. While this strategy improved efficiency, it also reduced the redistributive strength of the fiscal system.

In recent years, policy efforts such as the **New Tax Regime (2020)**, **faceless assessments**, and **digital filing systems** have sought to simplify compliance and increase transparency. Yet, challenges remain in integrating informal sector incomes, controlling tax avoidance, and aligning fiscal policy with social welfare objectives.

This research paper, therefore, seeks to explore the complex interplay between personal income tax and economic inequality in India. It examines historical trends, evaluates the progressivity of the tax structure, and analyzes how effectively tax revenues contribute to equitable development. The study also compares India’s experience with global benchmarks, offering insights into policy reforms necessary to strengthen the redistributive impact of personal income taxation.

Ultimately, understanding this relationship is vital not only for economic efficiency but also for **social justice and democratic stability**. Reducing inequality through a fair and transparent tax system can promote inclusive growth, enhance citizen trust, and ensure that the benefits of India's economic progress are shared more equitably across all sections of society.

2. Objectives of the Study

The primary objectives of this research are:

1. To examine the historical evolution of personal income tax in India.
2. To analyze the relationship between personal income tax and income inequality.
3. To assess the effectiveness of India's tax structure in achieving equitable income distribution.
4. To compare India's income tax system with global best practices.
5. To recommend policy measures for improving the redistributive impact of personal income taxation.

3. Conceptual Framework

Personal income tax represents a **direct tax** imposed on individuals' income from various sources. In contrast, indirect taxes such as GST are regressive, disproportionately affecting lower-income groups. A progressive PIT system, therefore, is essential for reducing inequality. However, the success of such a system depends on tax compliance, administrative efficiency, and government expenditure priorities.

4. Review of Literature

A review of existing research provides insights into the multidimensional relationship between income taxation and inequality.

1. **Piketty and Chancel (2017)** analyzed income distribution trends in India between 1922–2015, concluding that economic liberalization significantly increased top income shares despite progressive taxation.
2. **Kelkar Committee Report (2002)** emphasized simplification of tax laws to enhance compliance and reduce administrative burdens.
3. **NIPFP (2022)** found that personal income tax contributes marginally to overall revenue, limiting its redistributive function.
4. **OECD (2023)** reported that India’s personal income tax revenue accounts for only 17% of total tax revenue, far below OECD averages.
5. **World Bank (2024)** highlighted that fiscal redistribution through direct taxes remains weak in India, urging enhanced transparency and enforcement.
6. **Chakraborty (2018)** argued that tax policy reforms must be paired with social expenditure to effectively combat inequality.

The literature suggests that while India’s tax system has progressive intent, its implementation is hindered by structural challenges, including evasion, exemptions, and a narrow tax base.

5. Evolution of Personal Income Taxation in India

The Income Tax Act of 1961 laid the foundation for India’s direct taxation system. During the 1970s, extremely high marginal tax rates encouraged evasion, prompting later reforms. Post-1991 liberalization lowered rates, simplified procedures, and encouraged voluntary compliance.

The **New Tax Regime (2020)** introduced optional lower rates with fewer deductions, attempting to broaden the base. Yet, tax buoyancy and compliance remain weak, and the top 1% of earners continue to dominate national income shares.

6. Relationship Between Personal Income Tax and Economic Inequality

6.1 Tax Incidence

India's PIT is theoretically progressive. However, the effective tax rate decreases with rising income levels due to numerous exemptions and deductions. The agricultural income exemption, for instance, often benefits wealthy landowners.

6.2 Tax Evasion and Informal Economy

Over 80% of the workforce operates in the informal sector, which largely escapes taxation. As a result, the redistributive power of PIT is restricted, and indirect taxes (which burden the poor) dominate revenue collection.

6.3 Revenue and Redistribution

Table 1 presents data on personal income tax as a share of GDP and total tax revenue in India over recent years.

Table 1: Personal Income Tax Trends in India (2015–2024)

Year	Personal Income Tax as % of GDP	PIT as % of Total Tax Revenue	Taxpayers (in millions)
2015	1.8%	16%	48
2017	2.0%	17%	55
2019	2.2%	18%	63
2021	2.3%	19%	68



Year	Personal Income Tax as % of GDP	PIT as % of Total Tax Revenue	Taxpayers (in millions)
2023	2.5%	20%	74
2024	2.6%	21%	78

Source: Ministry of Finance (2024); Economic Survey of India.

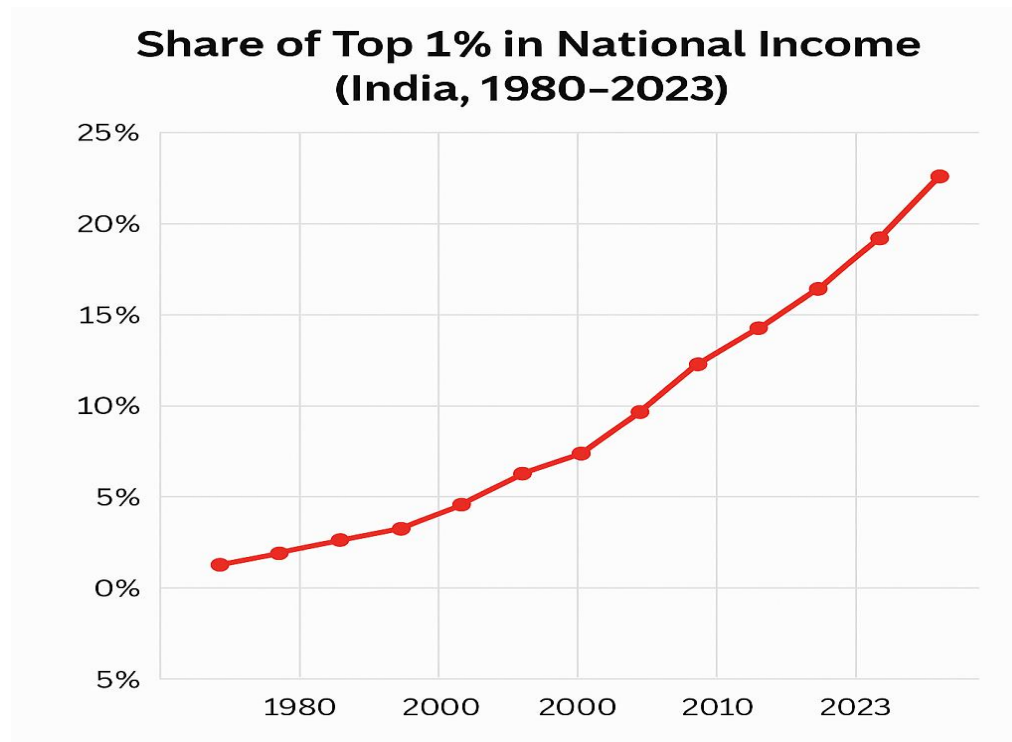


Figure 1: Share of Top 1% in National Income (India, 1980–2023)

7. Comparative Perspective

In OECD countries, personal income tax accounts for 35–45% of total tax revenue. These nations employ highly progressive tax brackets and robust compliance systems. In contrast, India’s dependence on indirect taxes makes its overall fiscal system regressive. Countries such as Brazil and South Africa have integrated digital compliance, wealth taxes, and strong social transfers, demonstrating more effective redistribution.

Figure 2: Composition of India’s Tax Revenue (2023–24)

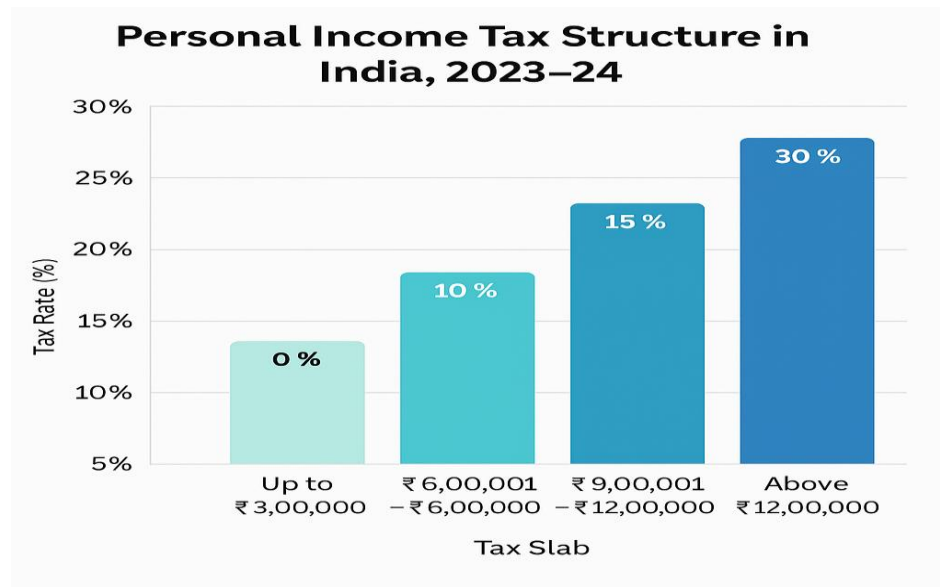


Table 2: Comparative Analysis of PIT Systems (India vs OECD Average)

Indicator	India	OECD Average
PIT as % of GDP	2.6 %	8.5%
Tax Compliance Rate	~60	95%

Indicator	India	OECD Average
	%	
Share of Direct Taxes in Total Revenue	41%	67%
Gini Coefficient (Post-tax)	0.47	0.31

Source: OECD (2023); NIPFP (2022); World Bank (2024)

8. Theoretical and Analytical Discussion

The **Keynesian framework** suggests that progressive taxation can stimulate demand by redistributing income. However, India's limited PIT base undermines this mechanism. **Neoclassical economists** warn that excessive taxation discourages investment, leading to inefficiency.

The **modern political economy** approach emphasizes institutional capacity—without transparency and strong enforcement, progressivity loses its impact.

9. Challenges in the Indian Context

1. **Tax Evasion:** Rampant underreporting and weak audits.
2. **Narrow Base:** Only about 6% of citizens file returns.
3. **Agricultural Exemption Abuse:** High-income earners avoid taxes under false claims.
4. **Administrative Inefficiency:** Lengthy litigation and low technological adoption.
5. **Regressive Indirect Tax Burden:** GST and excise taxes disproportionately affect low-income households.

10. Policy Recommendations

1. **Broaden the Tax Base:** Include wealthy agriculturalists and professionals in the informal economy.
2. **Enhance Progressivity:** Introduce higher slabs for ultra-rich taxpayers and reduce non-essential exemptions.
3. **Simplify Tax Regime:** Merge old and new regimes for clarity.
4. **Strengthen Enforcement:** Deploy AI-driven audits and digital verification.
5. **Improve Redistributive Spending:** Allocate PIT revenue toward healthcare, education, and job creation.
6. **Promote Tax Morale:** Create awareness of how taxes fund welfare and infrastructure.

11. Future Outlook

India's path toward becoming a \$5-trillion economy requires a tax system that promotes both efficiency and fairness. Digitalization initiatives like **e-filing**, **PAN–Aadhaar linkage**, and **GST data integration** have laid the groundwork for reform. The coming decade offers a unique opportunity to reimagine taxation as an engine for **inclusive growth** rather than mere revenue collection.

12. Conclusion

The relationship between personal income tax and economic inequality in India is defined by paradoxes—progressive in theory, yet regressive in practice. The system's limited reach, high evasion, and reliance on indirect taxation weaken its capacity to reduce inequality. A comprehensive reform agenda that prioritizes transparency, compliance, and redistributive justice is vital for achieving balanced economic growth and social equity.

References

1. Government of India. (2024). *Economic Survey of India 2023–24*. Ministry of Finance.

2. World Inequality Database. (2023). *India Inequality Report*. Retrieved from <https://wid.world>
3. National Institute of Public Finance and Policy (NIPFP). (2022). *Taxation and Redistribution in India*. New Delhi.
4. Piketty, T., & Chancel, L. (2017). *Indian Income Inequality, 1922–2015*. World Inequality Lab Working Paper.
5. Organisation for Economic Co-operation and Development (OECD). (2023). *Revenue Statistics in Asia and the Pacific 2023*. Paris: OECD Publishing.
6. Kelkar, V. (2002). *Report of the Task Force on Direct Taxes*. Ministry of Finance, Government of India.
7. Chakraborty, P. (2018). *Fiscal Policy and Inequality in Emerging Economies*. *Economic and Political Weekly*, 53(14), 62–70.
8. World Bank. (2024). *India Development Update: Fiscal Sustainability and Inclusive Growth*. Washington, D.C.
9. Reserve Bank of India (RBI). (2023). *Handbook of Statistics on the Indian Economy 2022–23*. Mumbai: RBI Publications.
10. International Monetary Fund (IMF). (2024). *Fiscal Monitor: Balancing Growth and Fairness*. Washington, D.C.
11. Ministry of Statistics and Programme Implementation (MoSPI). (2023). *National Accounts Statistics of India*. Government of India.
12. Bhattacharya, R., & Singh, P. (2022). *Direct Taxes and Inclusive Growth: Evidence from India*. *Indian Journal of Economics and Development*, 18(3), 45–58.
13. Gupta, S. (2021). *Tax Reforms and Equity in India*. *Journal of Public Finance and Policy*, 4(2), 77–95.
14. United Nations Development Programme (UNDP). (2023). *Human Development Report 2023/24: Breaking the Inequality Trap*. New York: UNDP.
15. Sinha, A. (2020). *Taxation, Informal Sector, and Economic Development in India*. *Asian Economic Review*, 62(1), 35–56.



-
16. Centre for Economic Studies and Planning (CESP). (2022). *Fiscal Redistribution and Inequality in India*. New Delhi: Jawaharlal Nehru University.
 17. Banerjee, A., & Duflo, E. (2019). *Good Economics for Hard Times*. New York: Penguin Random House.
 18. National Council of Applied Economic Research (NCAER). (2022). *Assessing the Tax Buoyancy and Revenue Potential in India*. NCAER Policy Paper No. 47.