Chapter 7

REFORM OF PERSONAL TAXATION IN INDIA

Personal taxes in India have been in force for over a century and constitute an important source of revenue for the Central Government, as also State Governments who share them under the federal scheme of the constitution. Income tax had a chequered career in the early years of its existence. Introduced in 1860, it was withdrawn after a short period; but was reintroduced in 1886. Since then it has continued as an integral part of the Indian tax structure. It was restructured in 1939 with the rates being designed on the slab system – a system that has basically continued since then, although variations have been frequent. Various exemptions, allowances, rebates and deductions have been improvised, modified and sometimes deleted; some have occasionally been reintroduced.

A scheme comprising distinction between earned and unearned incomes was introduced and later withdrawn, to be replaced by a direct standard deduction on salaried income which exists to this day. Various schemes were improvised to give a fillip to savings and investment and these have undergone changes from time to time. Surcharge on income-tax continues to be imposed, although rates thereof have been varied according to exigencies of the situation. In the 1994-95 Budget, surcharge on personal incomes had been withdrawn.

Exemption is provided for income from exports; while partial exemption from tax is granted in respect of donations made to eligible donees. Since agricultural taxation is allocated to the States under the Constitution, the Income tax Act provided for partial integration of agricultural incomes with general incomes since 1973 for rate purposes only. The implication is that while the agricultural portion of the income does not bear tax, it imparts an upward thrust

to non-agricultural incomes thereby subjecting them to higher rates of tax. But this is a poor substitute for a direct tax on agricultural incomes which escape taxation. This constitutes a major lacuna in the Indian tax system and persists to this day.

Wealth tax, gift tax and expenditure tax were introduced in the 1958 Budget, although expenditure tax was later withdrawn. Estate duty constituted a part of the tax structure for a number of years, but was abolished some years ago. Compulsory deposit scheme, introduced to mop up purchasing power from the tax paying public, was later abandoned. While the Indian tax structure no doubt is a fully developed system, it is also highly complex, despite periodical efforts to simplify it.

It is imperative for a developing economy that the tax system provides incentives and opportunities to work, save and invest in capital assets, to take risks and innovate, to use resources efficiently and to allocate them to uses which fulfil people's requirements and aspirations. Revenues have to be raised without adversely affecting economic opportunities and incentives. But distributional measures are also necessary in a society where a large percentage of the people are living below the poverty line. Since the criterion of efficiency requires low marginal rates of tax and vertical redistribution calls for high marginal rates on the richer classes, some conflict between these criteria is inevitable. A good tax system should minimize this conflict, and promote the desired level of redistribution with the loss of efficiency being kept at a minimum.

7.1. Limits to Collective Savings and High Taxes

The Indian tax structure during the last few decades has been reoriented to the increasing demands of a developing economy in which the state was envisaged to play an important role. Increase in taxes in such a context becomes perhaps an inevitable concomitant of economic development; yet a good tax structure for an underdeveloped economy must conform to certain basic principles: it

must not offend equity; it should promote efficiency; it should not siphon off funds otherwise going towards productive investment; and it should promote development. Economic growth postulates capital formation and, in this context, the maintenance of incentives to work, save and invest at a high level constitutes a prime objective of taxation policy.

An increase in national income and higher standards of living constitute the test of successful economic management and planning. But the chief requirement for developing countries is that of accelerating the pace of capital formation, so that the vicious circle of low savings and low investment is broken and the country reaches the stage of self-sustaining growth.

It may be possible for a totalitarian country to pin down standards of living, while saving the total increment in real incomes for investment purposes. But for a democratic country like India, where poverty is extreme, planning must also allow for a rise in the standard of living. Besides, the effect of the increase in population has also to be offset. The implication is that the increase in incomes must be substantial enough. This implies a very high level of capital formation and what is necessary is that the capacity to save must increase.

The country's fiscal policies must be so attuned as to maximize the amount of savings with corporations and the public. The reorientation of the tax structure during the last few years has resulted in a squeeze in corporate savings.No doubt finance corporations and credit institutions have assisted in development by providing long-term loans and capital, but ploughing back of profits is the best form of industrial finance,and this has been adversely affected due to increased taxation of the corporate sector.

Some policies are dictated by ideological considerations. The words of Dr. Ludwig Erhardt,[1]the architect of German reconstruction, in his book 'Prosperity Through Competition' are remarkable in this context : 'The successful rehabilitation of my country must serve as clear documentary evidence, to put before the still

vacillating and doubting peoples, of the fact that only by firmly rejecting socialistic dogmas, of whatever complexion, and by affirming a free economic order can mounting prosperity and genuine security be achieved'. Tax concessions given by the Government in West Germany stimulated industrial activities. Within a short period of less than a decade, the country reconstructed its economy and is today industrially ahead of various European countries. The German Government wisely acted on the principle that tax concessions provide the scope and incentives for saving and investment,leading to capital formation at an accelerated rate.

Besides, on balance, the government does not lose on account of tax concessions.Economic expansion and increased real incomes provide increasing revenues to the government, and the total volume of taxes is higher at the lower rates. The increased revenues sustain a higher rate of public expenditure and investment. This doctrine applied to India would imply that the regulations and controls upon private enterprises should be relaxed so as not to stifle initiative and enterprise and thereby hamper economic growth. The present liberalization policy is highly commendable and should be pursued to its logical conclusion.

It is said that taxation is a form of compulsory savings and is desirable, but it must be realized that taxation by itself only leads to a transfer of funds from private to public coffers, and not necessarily of funds which would have gone to consumption. Its effectiveness in promoting capital formation is limited by the extent to which the increased revenues are used for productive investment. If they are absorbed by an increase in administrative or non-development expenditure, the capital is virtually lost to the economy. Experience has shown that a sizeable part of the enormous increase in revenue due to increased taxation did not ultimately result in capital formation.

High levels of taxation,besides reducing the capacity to save on corporate and individual levels,have a disincentive effect upon investment. The decrease in the net marginal productivity of capital, besides inhibiting domestic investment,

also adversely affects the flow of private foreign investment capital into the country. What is necessary, and this is important, is to carry taxation only up to the stage where its adverse effect upon private savings and the inducement to invest is balanced by the benefit that can be derived by the economy through public investment for capital formation. So far as this country is concerned, that stage has been reached, and direct taxation with the existing base appears to have reached its limits. The base needs to be widened.

The emphasis on collective savings in the past has resulted in high rates of taxation.It has also been supported by the principle of ability to pay. It is urged that because of the principle of diminishing marginal utility as applied to incomes, there should be progressive scale of taxation. Besides, progressive taxation was regarded as an instrument for reducing inequality in society. During the last few decades before the eighties, the tendency had been to increase taxation to the maximum possible levels. The Taxation Enquiry Commission[2] recommended the principle of collective savings and reduction of inequalities through heavy income taxation; it stressed on the desirability or striving by steps for implementing ceiling on personal incomes.

The whole concept of collective savings and reduction in inequalities through high rates of taxation suffers from deficiencies. The modern trend in taxation is to reduce the level of taxes and simplify the structure. Firstly, high taxation reduces incentives, while for a developing economy it is imperative that savings, investment and incomes increase to the maximum, so that growth is stimulated. Secondly, progressive taxation has failed to reduce inequalities. If taxes are taken to levels which are almost confiscatory, people feel that the tax system is inequitable and unjust, and they have no moral obligation to comply with such tax laws, and voluntary compliance suffers.

If mixed economy is accepted and it has to function effectively and economic growth has to take place, there is no alternative but to provide incentives for

private savings and investment, though it may lead to some inequalities in income and wealth. The main objective is to raise the standards of living of millions of people and some degree of inequality has to be tolerated. After all, provisions for social welfare schemes and providing social security to the masses – in fact all transfer payments –, can only take place if the state has sufficient revenues, and incomes and savings can be buoyant only if economic growth takes place. The concept of economic power has lost much of its significance, since there are many checks and balances, particularly with the enormous powers of regulation by the state. Banking and insurance have been nationalized. Besides, a number of financial institutions and mutual funds with command over large resources, have emerged; they are mostly under the control and direction of the state. Actually a large-sized industry can hardly be set up in the private sector without some amount of institutional finance.

7.2 Characteristics of a Good Tax Structure

The tax system should have stability which is conducive to realistic corporate planning. Frequent changes in tax structure and rates of taxation lead to dislocation in the budgets and projections of corporations. Stability in tax laws is necessary for industrial growth and corporate planning.

The Meade Committee[3], constituted in 1978 to examine the structure and reform of direct taxation in the U.K., stated that 'in addition to being effieient and just and compatible with the country's international position, a good tax system should also be coherent, simple and straightforward... Tax burdens which are disguised by inflationary movements of prices, or by complexities in the devising or the administration of the tax, or by uncertainties in its application cannot properly meet this criterion of simplicity'. It should be clear to the taxpayer what is and what is not taxable; there should be certainty about the amount of tax payable; and it should be acceptable to the public. Another aspect of simplicity is the ease of its administration, ease of understanding by the taxpayer and ease

of its compliance by him. Judged by the above criteria, our tax system can hardly be described as simple; actually it is almost at the other end of the spectrum.

The basic point is that the tax structure should be acceptable to the public. If the tax system is too complex and the tax rates are very high – being almost confiscatory – the public may feel that they have no more obligation to pay taxes, which are inequitable and unjust. It would lead to large-scale evasion and avoidance. But, if the tax structure is reasonable and simple, it would definitely encourage voluntary tax compliance. The experience in many countries which have reduced taxes is that it leads to better revenues, both on account of increased work, incomes and savings, and also because of improved compliance. Besides, if the taxes are reasonable and low, the gains from tax evasion and avoidance are so marginal, that people prefer to pay taxes, rather than face penalties and prosecution. For an under-developed economy, the principal objective of taxation policy is to achieve economic growth through capital formation. The quantum of total tax revenue raised and the methods of raising revenue should be such that they do not adversely effect economic opportunities and incentives.

There are two aspects of the effects of a tax : the income effect and substitution effect. It the taxes are very high, a person may work harder to increase his post-tax income so as to compensate for the loss due to taxes. This is described as the income effect. However, a high marginal tax rate reduces the net spendable income which obtains from an extra day's work and this reduction in his command over extra goods owing to extra work will have a tendency to make him prefer lesser work. This is known as substitution effect, and it leads to inefficiency and waste. An industrialist may not expand his activities, leading to more efficient use of resources, because the increase in his profit after tax is unattractive. He may substitute an easy life for hard work and consumption of energy. A saver may substitute present consumption for future consumption by himself or his heirs because of the tax on the yield from his savings. High wealth tax and estate

duties may have similar effect. Since economic growth postulates accumulation of capital and its investment in productive assets, this principle is of importance, particularly for under-developed countries.

Besides, the tax structure should be such that it leads to international tax harmonization. This is of great importance for European countries, which are members of the E E C. Efforts are being made in various continental countries in this direction, but progress is limited because each country seeks to fashion its structure according to the needs of the state, the level of its social security system and the economic environment within the country.

A good tax system should have 'horizontal equity', which implies that persons who have the same taxable capacity should be treated alike, and they should bear equal tax burdens. Our tax structure suffers from certain infirmities: (a) the tax base is not sufficiently wide and does not cover a large number of persons who have assessable incomes; (b) certain classes of taxpayers, like those having high agricultural incomes, do not pay income tax, while others with similar business or other incomes, have to bear the brunt of taxes; and (c) due to widespread tax evasion and avoidance, certain people pay less taxes than what is due, casting a greater burden on those who properly pay taxes.

7.3 Canons of Taxation

Adam Smith[4] laid down certain canons of taxation which are largely valid even today, both in developing and developed countries, and may be considered. According to the principle of equality, the subjects 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. This is based on the principle of ability to pay. The quantum of tax payable should be definite, so that there is no scope for exercise of discretion or arbitrariness, as this may lead to corruption in administration and harassment of the taxpayer. This is the principle of certainty.

The tax which each individual is bound to pay ought to be certain. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person.

The payment of taxes should be so staggered that the mode and timing of payment cause the least inconvenience to the taxpayer. The modern system of 'pay as you earn' (P A Y E) or advance payment of tax, are in accordance with this principle of convenience. But for tax deduction at source from salary and advance payment of tax, taxpayers would be faced at the end of the year with a huge liability and would experience considerable difficulty in paying the taxes. The cost of tax collection should be the absolute minimum. Adam Smith, emphasizing the principle of economy, says that if taxes are wasted in the form of excessive expenditure on collection, taxpayers would try to evade them.

R. J. Chelliah has expounded certain principles which are highly relevant to underdeveloped economies. He has emphasized the mobilization of economic surplus. The development process results in increase in incomes. The surplus in a person's income comprises the excess above the level needed to maintain the minimum consumption necessary for maintaining efficiency and incentives. An effective tax structure should identify the surplus and either through taxation or incentives for investment channelize the surplus into productive investment. According to Chelliah,[5] the principle is that 'each person should be made to contribute to taxation in accordance with his unused capacity or ability to contribute to economic development'. This ability is reflected in that portion of the economic surplus which he is not utilizing for productive investment. Consumption should not be allowed to increase proportionately to rise in incomes. The incremental savings ratio should be maximized.

The tax structure should have built-in income-elasticity, so that taxes automatically rise in response to increase in national income. It is necessary, in order to impart the requisite flexibility to the tax structure, to impose indirect

taxes on commodities which have a high income-elasticity of demand. Besides, the scale of income taxes should be progressive, so that the marginal rate of tax is higher than the average rate, and government's intake of revenues increases more than in proportion to a rise in incomes. The burden of development must be equally distributed among various sections of society. Taxation involves sacrifice and people, in similar circumstances and utilizing the surplus similarly, should be treated equally for tax purposes. This is in accordance with the principle of horizontal equity. The Indian tax system does not satisfy this criterion. The tax system should provide a broad and diversified base for raising revenue for the activities of the state. Low rates of tax over a large tax base cause less distortion than raising the same revenue by imposing high rates of tax on a few activities. The Government has therefore to rely on a tax system which is constituted of a number of different taxes, rather than to rely only upon one or two taxes; this helps in keeping down the marginal rates of tax. When the tax system is diversified, it is necessary to ensure that the various direct taxes constitute a coherent whole; that they do not impinge on each other and there is no inconsistency between the rules framed for their implementation. This may be illustrated. The rules for valuation of properties for wealth tax, estate duty (now abolished), and gift tax should have uniformity. This would also contribute to simplicity of the tax structure.

The tax system should be so devised that it is productive of revenue, sufficient for the needs of the various activities of the state. This is the principle of revenue productivity. The modern state has ceased to be just a law-enforcing agency with defence and external affairs as adjuncts; today its operations embrace a large range of functions. Above all, the concept of the welfare state has been universally accepted, and government's activities cover a broad spectrum, ranging from poverty alleviation programmes, provision for infrastructure, economic and social, and accelerating economic growth, to running selected industries with

sophisticated technology, atomic power plants, implementing space and scientific research, and producing defence equipment, besides the traditional functions. The tax system has to provide for the collection of adequate revenues for these multifarious activities and provide for transfer payments.

We have discussed the beneficial effects of tax cuts upon economic activity. It is somewhat anomalous that in certain developing countries, the tax levels both on personal and corporate incomes are higher than in developed countries. Actually, taxes in the former should be low so as to provide incentives for capital formation, as also inflow of foreign investment capital. We are of the distinct opinion that the tax levels in economies which are in the transitional or pre-take off stage and the take off stage should utilize a part of incremental revenues for purposes of reduction in the burden of taxation. This would stimulate savings and investment in the household sector, accelerate development, and constitute an important factor in enabling the economy to reach and transcend the stage of self-sustaining growth and speed up its drive towards maturity.

Two New Canons for Stimulating Growth

In this context, we would advocate two new canons of taxation for developing economies: one relates to reduction in taxes for stimulating growth out of incremental revenues. As increment in tax revenues takes place from year to year in response to stimulated growth, a certain percentage should be set apart for reduction in personal and corporate levels of taxation. Thus the excess of revenues in any year over the revenues of the previous year should be appropriately divided – say in the ratio of 20 : 80 – between tax reduction and increased public expenditure. This would reinforce the contributory factors to growth and stimulate economic activity. This canon is based upon practical experience. Japan achieved excellent economic progress during the period 1960-69, when its G D P grew on an average by above 10 per cent per annum. The

Tax Commission[6] in its Interim Report in 1960 stated, (a) that the tax burden should be limited to about 20 per cent of national income; and (b) that a part of the increase of revenue resulting from high economic growth should be used as resources for reduction of taxes every year. The Japanese Tax Bureau, Ministry of Finance, states 'Thus, throughout this period (sixties), one of the characteristics of the major tax policies was a series of tax reduction programmes, in accordance with the recommendations of the succeeding Tax Commissions, which all insisted on alleviation of income tax burden.' The spectacular growth of the Japanese economy during this period bears testimony to the beneficent effects of this programme, although no doubt this was only one of the principal contributory factors.

The other new canon of taxation is that for developing economies, in order to maximize the incremental corporate savings ratio, that is, the ratio of savings or profits transferred to reserves for being ploughed back into business to the total profits after tax, the tax on undistributed profits should be less than the tax on profits distributed as dividends. Thus, if corporate tax is 50 per cent, the tax on the amount transferred to reserves should be about 30 per cent. This measure, in-built in the tax system, would automatically provide the incentive to plough back profits for expansion, modernization, and growth. The Government of Greece has recently (1989) proposed that 25 per cent undistributed profits of companies for the years 1988-91 would be exempt from taxation, provided they are wholly invested by the companies by the end of 1992. If the investment is in high technology sectors, the exempt portion would increase to 35 per cent. This reinforces our plea.

The tax authorities should engender in the assessees the feeling that they will receive fair treatment and will not be harassed. The prime requisites for this are that the tax structure is equitable and fair; taxes are administered in a reasonable manner; the assessees' rights and interest are protected; and above all, the

administration itself develops a degree of trust in the taxpayer. The system that has been adopted recently in India, namely of accepting the returns of the assessees without scrutiny is a move in the right direction. If the assessee feels that unnecessary disallowances will not be made by the department, be would be more likely to make an honest declaration. Of course, the department continues to conduct detailed scrutiny of a certain percentage of returns and where evasion is noticed, deterrent penalties are levied. The system allows time to the assessing officers to concentrate their energies upon difficult cases. The scheme as a whole is commendable and should encourage voluntary compliance.

7.4 Reform of Indian Tax Structure : Kaldor's Proposals and Subsequent Changes

If innovative taxation is regarded as an index of progressive fiscal policy, the Indian tax structure would probably get the cake. Over the past few decades, we have experimented with various kinds of taxes; and on the basis of experience, certain of the innovative measures have been subsequently withdrawn. A consequence of the fiscal experimentation was that at one stage, the tax structure comprised not only of income tax and wealth-tax, but also a formidable array of taxes including estate duty, expenditure tax, gift tax and capital gains tax, as also wealth-tax on companies (later withdrawn). The bonus shares tax and dividend tax had also been improvised; they did immense harm to the capital market, and were also subsequently removed from the statute book.

Nicholas Kaldor's[7] scheme of tax reform (1956) and the Government's paper on simplificaton and rationalization of tax laws (1986) constitute milestones in fiscal history. Although expenditure tax–the *piece de resistance* of Kaldor's proposals – was twice introduced and withdrawn, and his other proposals partially implemented and modified from time to time, it cannot be denied that the scheme has left its impact upon the tax structure. The Government's scheme of simplification is in the course of implementation, although some of the proposals

have run into difficulties and are being withdrawn. It is proposed to broadly discuss and evaluate these schemes. Thereafter, we delineate a comprehensive framework of tax reforms, directed towards rationalization of the tax structure, with a view to moulding it into an instrument for promotion of savings, investment and growth, while rendering it equitable, efficient and capable of inspiring trust in the assessee.

The 1958 Budget, based on Nicholas Kaldor's recommendations, imposed an annual tax on wealth, gift tax and an expenditure tax. Kaldor's recommendation that the introduction of these taxes should be accompanied by a reduction in the highest marginal rate of tax to 45% (plus surcharge) was more or less ignored, although the maximum rate of income-tax was brought down from 91.9% to 84% (including surcharge). Kaldor's recommendations were based on three principal grounds : (1) administrative efficiency would increase, as the assessees would have to file comprehensive tax returns in respect of wealth, income and expenditure, and the fact that they would have to maintain consistency in their returns, would ensure that they would be self-checking. The efficiency of the system would also be enhanced as taxes would be levied both on income and property, which were interrelated. (2) Kaldor claimed that his system of taxation had the merit of equity; 'the ownership of property in the form of disposable assets endows the property owner with a taxable capacity as such, quite apart from the money income which that property yields'. Income alone was not an adequate yardstick of taxable capacity, and also as between income from work and income from property, and between different property owners. Hence, wealth tax and estate duty were necessary, so that taxes could be levied on the basis of this additional taxable capacity. (3) As regards economic effects, income tax discriminated against risk-taking, while taxes on capital did not discriminate against employment of capital in risky ventures. Kaldor wanted capital gains also to be included in taxable income. Since increasing urbanization was taking place, it was necessary to tax capital gains. The Government in implementing

Kaldor's scheme of taxation felt that it would also lead to distributive justice and reduce inequalities.

Theoretically, the expenditure tax is ideal in that by taxing expenditure, the state should be curbing extra consumption. The basis of computing it is that taxable expenditure is generally regarded as income less approved investment, which is equal to expenditure plus investment in unapproved assets. Difficulties in computing expenditure arise because wealth at the beginning of the year and at the end of the year have to be worked out, which together with the mode of disposition of income during the year, gives the expenditure. Thus the taxable expenditure is a derived figure. This computation gives rise to various practical difficulties. Besides, if expenditure tax is not to replace income tax, but is an additional tax, it adds to the burden of the taxpayer, causing considerable inconvenience; and the revenue yield is hardly much. In an economy where there is considerable amount of black money, a good part of the unproductive expenditure of assessees would be met out of black monies and escape the net of expenditure taxation. As is well known, an expenditure tax on Nicholas Kaldor's recommendation, was introduced in India and later withdrawn, as it proved to be too cumbersome, without yielding revenue commensurate with the effort.

The same effect, more or less, as the expenditure tax, can however be achieved by providing incentives for saving and investment in approved channels, while discouraging investment in unapproved channels like gold, silver and land, which do not yield income but are subject to wealth tax. The Indian tax structure already provides such incentives, as also wealth tax.

The net effect of all the taxes imposed in 1958 was that the burden of taxation on the assessees increased considerably, and due to the complexity of the tax structure, and the number of returns that had to be filed, there was great dissatisfaction among the people. Instead of the tax system being acceptable and inducing voluntary compliance, the whole scheme became counter-productive.

What Kaldor had not envisaged was that if the tax structure was cumbersome and the tax burden heavy, it would tend to increase, rather than check, evasion.

It was gradually realized by the authorities that the expenditure tax failed to generate sufficient revenues commensurate with the effort on the part of the administration and the assessees, nor had it fulfilled its objectives or rendered the system more equitable. The tax was withdrawn. Theoretically also, Kaldor's proposals were contradictory. R. J. Chelliah[8] says 'it is somewhat surprising to find Kaldor advocating a wealth tax in addition to taxation of capital gains, after all his inveighing against 'the double taxation' of savings'.

7.5 Level of Taxes and G D P Growth

Conducting a survey of the experience of the impact of taxation on growth in twenty countries, covering almost the entire spectrum of world incomes, Keith Marsden,[9] in a World Bank study, notes

'In all cases, the countries that imposed a lower effective average tax burden on their populations achieved substantially higher real rates of GDP growth than did their more highly taxed counterparts. The average (unweighted) annual rate of growth of G D P was 7.3 per cent in the low-tax group and 1.1 per cent in the high-tax group'.

The low-tax countries included Japan, Spain, Singapore, Korea, Brazil, and Thailand, while the high-tax countries, inter alia, included the UK, Sweden, New Zealand, Chile, Jamaica, and Peru. While tax-G D P ratios rose in most of the countries during the period under study, the relative tax position between low-tax and high-tax countries remained almost the same. The average tax - G D P ratio in the low-tax countries increased from 13.3 per cent at the beginning of the decade to 15.2 per cent at the end, while it rose from 21 per cent to 23.9 per cent in the high-tax group. This rise in the low-tax countries mainly reflected a widening of the tax base, rather than an increase in tax rates, although it coincided with

a general reduction in the rate of economic growth (G D P) during the second half of the seventies.

Consequent upon high rates of economic growth in low-tax economies, higher levels of consumption and substantial rise in real living standards were achieved. High growth rates and increased revenues, associated with expansion of the tax base, provided funds for considerable increase in social welfare expenditure by governments in these countries. Besides, the argument that distribution is more equitable in high-tax countries than those with low taxes, is not borne out by the study. The share of the poorest 40 per cent of households in total income remained relatively high between 16.9 per cent and 21.9 per cent in five fast growing, low-tax countries such as Japan, Korea, Malawi, Spain, and Thailand. The growth in investment averaged 8.9 per cent annually for the seventies in low-tax countries, as compared to a decline of 0.8 per cent annually in high-tax countries. There is correlation between tax-G D P ratios and investment growth. A rise in the tax ratio of 1 per cent was associated with a reduction of rate of growth in investment of 0.66 per cent, and amongst various taxes, high corporate income tax was the strongest deterrent to investment. The US experience confirms the results of this study : progressive reduction in corporate profit taxes would increase both business investment and capital stock substantially.

High taxes affect growth in two ways, according to the study : by adversely affecting the aggregate supply of the main factors of production by lowering their net return after tax, and by reducing the efficiency of resource utilization (total factor productivity). The more significant effects of taxes on growth in the lower income countries may be attributable to greater scope for productivity gains from the induction of modern technology and skills, transfer of capital and labour to more productive sectors, and 'externality effects'. In the higher income countries, productivity differences between sectors are much less and the existing

levels of efficiency higher. Structural rigidities have a restrictive effect upon the mobility of resources and inhibit the introduction of new techniques. These factors restrict their 'potential for tax-induced gains'. The Marsden study further shows that inflation rates were higher in high-tax countries in seven out of the ten pairs during the decade and seem to have exacerbated the negative effects of taxation on growth.

Harvard Professor Lawrence Lindsey[10] concluded from an econometric research that among people with taxable incomes above $ 200,000 by lowering tax rates the US Government in 1984 collected $ 8 billion more in revenue than it would have if taxes had remained at 1979 levels. Lindsey concluded that tax cuts pay their way and revenues increase. There is some kind of Laffer curve in operation. This curve established the relationship between taxes and revenues (and production) and is in the form of a parabola. There exists an optimum point on the curve where the taxes will maximize revenues and GNP. In countries with high rates of taxation, if the taxes are reduced, bouyancy in revenues increases because tax cuts induce people to work harder and there is stimulated economic activity, increased productivity and incomes. However, according to Prof. Lindsey, this accounts for only one-third of the increase in tax revenue. He believes that the balance two-thirds of increased revenues came from business and self-employed people who responded to lower taxes by cutting costs to maximize earnings. He believes that the highest rate at which governments are likely to maximize the tax intake is at around 40 per cent.

It is now clear that the era of high taxes – the socialist shibboleth – is over. They have been thoroughly discredited on various counts. They adversely impinge upon business enterprises and growth, and militate against buoyancy in revenues; they give a fillip to evasion and avoidance, and check voluntary compliance of taxes; and they encourage laxity in expenditure and reduction in cost consciousness, as more than two-thirds of the expenditure is in effect borne by

the revenue department. With winds of change sweeping over developed countries, who are virtually engaged in a race to cut taxes, developing countries have little alternative but to follow suit. Besides, so long as tax cuts pay their own way and result in increasing revenues through enhanced G N P and better compliance, it is in the interest of the exchequer to reduce them. The taxpayers are responsively happy, government revenues acquire buoyancy and, above all, the momentum of growth is accelerated. No finance minister can afford to ignore this triple-benefit formula, at least not in the present fiscal world environment. (Vide Section 6.3 regarding recent Indian experience).

Indexation of taxes is necessary to preserve the real, as distinguished from the monetary, structure of taxation and to prevent the rate of inflation from becoming an arbitrary form of taxation, giving rise to inequities and distortions. Income and wealth by and large constitute the bases for assessment of taxes; two distinct types of indexation are required in regard to them. Since modern taxes are progressive, both the threshold and the tax brackets in the rate schedule of income tax and wealth tax need to be indexed. Besides, indexation for capital income adjustment is necessary in order to reflect the real values of assets and liabilities and to determine real income. This includes adjustment in respect of depreciation, capital gains, stocks, and other items.

Although indexation of the tax structure has not been formally adopted by many countries with a developed tax system, they have taken cognizance of the factor of inflation, and certain adjustments have been made in order to mitigate the inequities and hardship imposed by an inflationary rise in the price level. Thresholds for tax exempt incomes have been raised, personal allowances and social security payments – a form of negative taxation – have been increased. In Britain, 100 per cent capital allowances have been provided for new plant and machinery, while stock relief has been granted to reduce the rigours of tax liability arising from an inflationary rise in the value of stocks.

7.6 Favourable Effects of Tax Cuts on Revenues

Direct taxes need to be pruned for stimulating growth; as also for curbing evasion and the generation of black money which contributes to inflation and other distortions in the economy. If cognizance is taken of this fact, the budgetary deficit should not act as a deterrent to the lowering of the personal and corporate taxes.

The maximum personal income tax rates were reduced in India from 97.75 per cent to 77 per cent in 1974-75, and to 66 per cent in 1976-77, operative above Rs. one lakh income (instead of Rs. 70,000). The revenues of the Central Government from income-tax were estimated to decline by Rs. 36 crores in 1974-75 and by Rs. 60 crores in a full year. Actually, such revenues rose by Rs. 130 crores from Rs. 744 crores in 1973-74 to Rs. 874 crores in 1974-75. The tax reduction in 1976-77 was also followed by an increase in revenue from Rs. 965 crores in 1976-77 to Rs. 1025 crores in 1977-78.

The Choksi Committee (1978)[11] in its Final Report states 'Apart from the pecuniary gain to the Exchequer in terms of additonal taxes mobilised and the gain to the economy from a reduction in the volume of unaccounted incomes, there is the more important gain in the improvement in the standards of public morality'. It concludes that, as in other parts of the world, the conditions in India also justify the 'progressive reduction in the rates of tax'. The maximum marginal tax rate was reduced for individuals to 50% from 61.875% in the Union Budget for 1986-87. The revenues of the Government from income tax increased from Rs. 2,509 crores in 1985-86 to Rs. 3,660 crores (B.E.) in 1988-89, an increase of 46% over three years. The maximum rate of personal income tax may be reduced from 40 per cent at present to 30 per cent and the progression should be smooth and even at all levels of incomes. The maximum rate should be applicable above Rs. 2 lakhs instead of Rs. 1.20 lakhs at present, which would reduce evasion.

Actually a higher level of economic activity itself results in higher revenues

with the same rates of taxation. A much bigger contribution to revenues can come from higher production. If a reduction in the excise duty on a particular product results in more than a proportionate increase in production and sale, the collection would also increase. Besides, with higher profits, corporate tax revenue might be stimulated.

A deduction from taxable income of 50% of the amount deposited with the Reserve Bank of India in fixed deposit, bearing usual interest, for five years out of current income upto Rs.20,000 per year may be considered for promotion of personal savings. The amount when received back should not be subject to taxation.

O E C D countries were all cutting taxes. Asian Development Bank (1993)[12] states

'Tax reforms in such industrial countries as Australia, New Zealand, the U.K. and the U.S. which have resulted in significantly lower nominal rates of individual and corporate income taxes, have met with quick appropriate response from these countries (N I E s and South-East Asian Countries) (Vide Table 7.5).. As South Asian countries begin to stress external linkages, they will need to re-examine their tax structures, considering comparability with their major economic partners as well as their competitors.. (and) restructure their tax systems to reflect the reorientation of their economic strategies towards integration with the world economy in a market consistent manner, (and for) maintaining international competitiveness.

7.7 A Review of Some Important Tax Laws

(a) Personal Taxes and Allowances

The position with regard to tax incidence on the basis of Union Budget 1994-95, with 31 March 1994 as the cut - off date may now be indicated. The estimated revenue from income tax for 1993-94 according to revised estimates was in conformity with the budgeted figure of Rs.9,500 crores, but according to

trends, it would probably cross Rs.10,000 crores. Similarly the revenue from corporation tax at Rs.10,500 crores was also in consonance with the budget estimate. (Vide Table 7.1) These were significant facts in the wider context, considering that estimated revenues (RE) from indirect taxes like customs and excise at Rs.22,500 crores and Rs.31,750 crores fell short of targets for 1993-94 by about Rs.5,230 crores and Rs.2,000 crores respectively.

While the exemption limit for income-tax had been raised from Rs. 30,000 to Rs. 35,000,* the tax rates were 20 per cent on income between Rs. 35,000 and Rs. 60,000, 30 per cent between Rs. 60,000 and Rs. 1,20,000 and 40 per cent thereafter. The surcharge on income-tax at 12 per cent above Rs. 1,00,000 had been withdrawn, with the result that the highest marginal rate had been pared from 44.8 per cent to 40 per cent (Vide Table 7.5) applicable above Rs. 1,20,000 as against the level of Rs.1,00,000 earlier. Status quo had been maintained in regard to standard deduction of Rs.15,000 in case of salaried employees (Rs. 18,000 for women).

Liberalization in economic policies had been reflected in taxes also. The actual incidence of income-tax on an income of Rs.1,30,000 per year in the case of a salaried employee with dividend and Unit income* of Rs.10,000 worked out to Rs.6,500, provided he took maximum advantage of the rebate in income-tax of Rs.12,000 offered on savings Rs.60,000 effected through provident fund, life insurance policy, and other schemes specified in Section 88 of the Income Tax Act.

Relaxation in respect of direct taxes was even more evident in the case of wealth tax. With effect from assessment year 1993-94, assets other than certain specified items, were outside the purview of Wealth Tax Act; these included shares, debentures, bank deposits, units, loans, advances *et al.* The taxable specified assets included jewellery, motor cars, yachts, boats and aircrafts, urban land and cash in hand in excess of Rs.50,000. The exemption limit for wealth tax was

* With effect from Assessment Year 1996-97, exemption limit for income tax raised to Rs. 40000; dividend and unit income exemption limit increased to Rs. 13000

increased to Rs.15 lakhs, and the rate of tax was 1 per cent on net taxable assets above this limit. It was also improvised that from the next year, a residential house irrespective of its value, would be wholly exempt from tax. In effect, the applicability of wealth tax had been severely limited either to the very affluent or persons who had sizeable holdings of unproductive assets.

The basic exemption limit in respect of gifts had been increased to Rs.30,000, while allowance for gifts to dependent relative at the time of marriage had been enhanced to Rs.1 lakh.The rate of taxable gifts above the threshold of Rs.30,000 continues at 30 per cent, which was on the higher side. A slab system, with taxable gifts below one lakh being taxed at 10 per cent and between 1 lakh and Rs. 5 lakhs at 20 per cent and thereafter at 30 per cent, would be more equitable. Actually, with wealth tax having been greatly liberalized and estate duty withdrawn, gift tax had lost its *raison d'etre* and should also be abolished. The revenue yield of gift tax at Rs. 5 crores was insignificant in the broader context.

(b) Capital Gains Tax

While short - term capital gains were taxed at normal rates, long - term capital gains arising in respect of shares and units held for more than a year were taxed at 20 per cent in the case of individuals and 30 per cent plus surcharge in the case of companies. Foreign institutional investors (F I I s) however, were taxable at 10 per cent in respect of long-term gains, at 20 per cent on interest, dividends and units, and 30 per cent in respect of short - term capital gains. These discriminatory rates were improvised to attract investment by F I I s, but this had drawn flak from Indian investors that level playing field in this regard had not been provided to them.

As the following table shows, the medley of rates on short - term and long-term capital gains, dividend, interest and unit income for different categories of income and taxpayers adds to the complexity of the structure without commensurate benefit to revenue. There should be only two rates for long - term capital gains: 10 per cent for individuals and 20 per cent for companies, while

Tax Rates on Capital Gains (1995-96)

Assessees	Income from Units	Income from Interest and Dividends	Short Term Capital Gains	Long Term Capital Gains
Foreign Institutional Investors & F. F. I.	10%	20%	30%	10%
Non-Resident Companies.	20%	20%	55%	20%
Indian Companies	40% plus Surcharge	40% plus Surcharge	40% plus Surcharge	30% plus Surcharge
Indian Individuals	Slab Rate 20/30/40%	Slab Rates 20/30/40 %	Slab Rates 20/30/40 %	20%

Source : *Economic Times*, New Delhi, 28 November 1994

short-term capital gains may be taxed liked normal income in all cases. Income from units, dividend and interest may be taxed at one - half the normal tax rates for all categories of taxpayers; and surcharge for companies in respect of capital gains may be withdrawn. This would contribute to simplification. It is relevant to observe that the Royal Commission on Taxation of Profits and Incomes in U.K. (1952) stated that capital gains in times of inflation were largely illusory. The inflation indexed adjustment of cost in calculation of long-term capital gains also adds to complexity. Greater transparency could be achieved by reducing the effective rate and withdrawing the adjustment which was only of marginal benefit to the assessee and constituted loss to revenue.

(c) Corporate Amalgamations and Reconstructions

The tax provisions with regard to capital gains tax and gift tax were not applicable in case of amalgamations to amalgamated companies and shareholders. But the tax laws had not improvised for other cases of reconstruction of corporate entities. Investment allowance, development allowance in case of tea companies, and carried forward depreciation and losses were jeopardized and lost. As K S Mehta[13] says 'The dictates of liberalization and competition require that businesses are restructured into single integrated industry companies where core competencies are developed for focused management; technology and financial alliances are invited'. It was a fact of life that businesses were divided. The newly constituted companies (comprising divisions of the earlier composite corporation) became 'engines of growth because management control synchronizes with ability to decide on (optimum) use of profits'.D C M Limited was divided into four companies and each restructured company showed profits greater than those of the original company. And this was not an isolated stance. Pent up energies were released and the new managements functioned with added vigour and dynamism, resulting in escalating profits – as also greater revenues for the exchequer. Since the schemes were sanctioned by high courts within the ambit of company law and well-defined procedures, there was hardly any scope for abuse.

Empirical evidence showed that despite carry forward of losses, acquisition of a large number of sick companies by healthy companies did not occur; this was because the acid test was viability. Unless the industry was capable of revival and profit generation, merger would not be effectuated. The conclusion was that mergers were essentially synergy-oriented and not necessarily tax avoidance devices. Mergers under section 72A should be permitted without conditionalities and carry – forward of losses and depreciation of amalgamated company made easily available to amalgamated company. This would facilitate rehabilitation of sick units. At present set off was allowed only in case of reverse mergers, or if sanctioned by B I F R. Section 72A of the Income Tax Act was too cumbersome and needed to be liberalized.

Chelliah Committee[14] rightly supports the plea that in the case of compromises, arrangements and reconstructions, as in the case of amalgamations, no capital gains tax or gift tax should be levied; it suggested amendment of Income Tax Act and Gift Tax Act in this regard. Chelliah Committee's recommendation for removal of surcharge on corporate incomes was likely to be implemented by the Government in the 1996-97 Budget and effective tax on corporations brought down to 40 per cent. Still personal and corporate tax rates were not wholly in alignment with international tax levels.

(d) Taxation of Agricultural Income

Prior to independence, the burden of land revenue was sizeable and accounted for half the net agricultural income. The surpluses were utilized for financing major irrigation and power projects, as also railways and urban development. However after the fifties, both investment in agriculture and prices of produce sizeably increased. Agricultural incomes also were enlarged, but the rates of land revenue remained stagnant, with the consequence that land revenue as a percentage of income from agriculture declined to one per cent.

The question of taxing agricultural incomes has defied solution, both due to political reasons and difficulties in implementation. K. N. Raj Committee in

the seventies recommended progressive taxation of agricultural landholdings, as accurate estimation of farm incomes was difficult. C. H. Hanumantha Rao[15] states that despite low net prospective accruals, 'there is still a case for taxing upper income groups in agriculture in the interests of inter-sectoral as well as intra-sectoral equity, particularly in areas experiencing the green revolution. Such a direct taxation of agriculture has however, proved to be politically infeasible'. Agricultural income tax is being imposed only by certain States. In the case of tea companies, 60 per cent of income is subject to agricultural income tax, while 40 per cent of the income is subject to Central taxes.

The Government's Discussion Paper on Simplification and Rationalization of Direct Tax Laws[16] sought to achieve uniformity in provisions of the three Direct Taxes Acts, which was to be a precursor to the formulation of a single Direct Taxes Code, comprising Income Tax, Wealth Tax and Gift Tax Laws. It is however mooted that the practical difficulties in implementation of the proposal would far outweigh the benefits, which also do not appear to be significant; the scheme has been shelved. However, harmonization of procedural and other provisions in regard to definitions, methods of valuation, appeals, rules and recovery proceedings may have utility.

The Estimates Committee of Parliament recommended abolition of estate duty, which was a highly complex piece of legislation, and suggested a surcharge on wealth tax payable by the deceased to replace it. The Government accepted the suggestion and abolished estate duty, which yielded about Rs.20 crores only. However, in the Union Budget for 1988-89, a tax on inheritance was mooted in consonance with the egalitarian principle of taxing inherited wealth, but the bill has lapsed. It is now urged that gift tax has become redundant in view of estate duty having been abolished and wealth tax rationalized.

(i) Agricultural incomes should be brought within the orbit of taxation. Agricultural incomes need to be transferred from the 'State List' to the

'Concurrent List' by amendment of the Constitution. Since many States are not utilizing their powers, they should not have objection to such transfer. The Centre can thereafter either through the Income Tax Act or a new Act impose agricultural income tax, and the proceeds could be shared with the states.

(ii) Commodities which enter into the expenditure budgets of upper and middle income farmers and other persons in rural areas should be subjected to higher rates of excise duties.

(iii) Land revenue should be restructured and rendered progressive. The present structure of land revenue is outdated and the revenue yield is inelastic.

(iv) Agricultural inputs should be subject to higher indirect taxation. It may be argued that this may adversely affect the small farmer, and impinge upon agricultural production. The marginal farmers may be given some form of compensatory assistance, but the basic idea is that prosperous farmers and landlords should be made to contribute to revenues. The fear that agricultural production may be adversely affected is unfounded, as there is adequate margin of profitability, owing to economies of scale. Larger holdings can bear additional taxation.

(v) A joint committee consisting of experts from the Finance and Agriculture Ministries should be appointed to study the problem of mobilization of taxes and savings from the rural areas. The reservoir of incomes and savings in rural areas is large, and considerable mobilization can take place. Efforts should be both extensive and intensive. Households should be approached and brought within the network of the small savings movement. This would also assist in improving the overall ratio of savings to G D P.

User charges for facilities and inputs, including energy and water supplied to the farmer, should be commensurate with the costs of these services. This

would also ensure their more effective utilization, and better allocative efficiency in their use.

7.8 A Review of Fiscal Administration

The efficiency of fiscal administration assumes great importance not only because it would be conducive to more effective implementation of tax laws and improved collection of revenues, but also because it contributes towards success of tax reforms, better relations between the tax officers and assessees and above all creation of a healthy tax climate which facilitates voluntary compliance of tax laws and improved taxpayer response.

Chelliah Committee[17] has given a graphic description of the fiscal administration and the tremendous difficulties faced by the Income Tax Department which has been making efforts at improvement, although 'what has been achieved falls far short of what is required'. The Committee states that the Income Tax and Customs & Excise Departments are called upon'to implement complex legislation and enforce high rates; the officers.. are not sure of support, if Audit should consider them at fault; over-assessments and disallowances are common and so are disputes, and litigation is prolonged.. Evasion is more often attempted to be checked by adding new provisions which further complicate the legislation and create dissatisfaction among honest tax payers. The Government on its part has been raising rates.. (and changing) tax laws continuously.. There is widespread agreement that the scale of evasion as well as the degree of corruption have been rising'. For improving tax administration, it is necessary to effectuate far-reaching changes in recruitment, personnel policy, matters of administration and in appellate procedures. Besides, simplification of laws and reduction in taxes, adoption of modern methods of communication, gathering and storage of information and widespread use of electronic data processing in various fields of tax administration are imperative.

Some recommendations for improving administration and voluntary tax compliance may be made: (1) distinguishing good assessees and giving them priority treatment in regard to assessment, refunds *et al;* (2) reducing scope for exercising discretion through simplicity and transparency of laws; (3) avoiding setting of unrealistic revenue raising targets; (4) providing for accountability of officers; discouraging excessive assessments; rewarding good work and integrity; (5) ensuring proper training of officers; and (6) setting up an equitably constituted Advisory Committee.

The principal problems facing the tax administration are largely due to the following factors: (1) high rates of taxes and various deductions and exemptions introduced in tax laws, (partly for realizing non - revenue objectives) and amendments year after year,and within the year also in the case of indirect taxes; (2) changes in law effected by the Government in secrecy without public debate; (3)fixation of unrealistic targets of tax revenue collection; (4) lack of accountability of assessing officers for over - assessments which are set aside; (5) fear of Audit objections; (6) departmental appeals without proper application of mind and prolonged litigation; (7) lack of adequate training of officers; (8) information systems not commensurate with the vast needs of administration and (9) inadequacy of computerization and application of modern methods.

Some recommendation for improving fiscal administration my be made as follows :

(a) Stability of Tax Laws

Tax laws should have stability and not be frequently amended. This causes inconvenience to both the assessee and the assessing officers in implementing the law. It makes tax planning difficult and creates uncertainties. The establishment of a 'Tax Research Bureau' which would study various suggestions made, and formulate proposals for amendment which may be circulated for public debate is desirable. Once in five years, the minimum amendments considered necessary should be effected.

(b) Self Assessment System

The self - assessment system has proved to be a success in that the I. T. Department is able to devote greater amount of time to bigger and difficult cases. There is also placement of greater faith in the assessees, which has helped in improving levels of returned income. But cases for scrutiny should be selected by the higher echelons in the Department at the beginning of the year and the assessing officer should not have any power to exercise discretion in this regard, which is liable to misuse in certain cases.

(c) Tax Arrears and Compromises

An important problem facing the administration is that of mounting tax arrears and prolonged litigation. It is suggested that the Department may consider compromise of cases across the table as is being effected in the case of Non Performing Assets (N P As) of commercial banks. While formulating the scheme in this regard, adequate safeguards including review by higher authorities would have to be provided to ensure that the compromises are fair to both the assessee and revenue. Cases involving large amounts should be disposed of at the Board level. Alternatively, the settlement commission procedures should be considerably relaxed; what is necessary for success is to reduce formalities and rigidities. However, it appears that a new scheme for compromise across the table has much better chances of success.

(d) Concessions for Tax Compliance and Reducing Hardship

The new provisions regarding advance payment of tax are well - conceived and would contribute to better voluntary tax compliance even in cases where the assessee discovers after close of the year that his income is quite in excess of his earlier estimate. The rate of penal interest, however, should not exceed 18%. Provision for advance payment of taxation in respect of capital gains which cannot be anticipated, is anomalous and should be withdrawn or made payable only with the last March instalment.

The concept of reducing discretion in the hands of taxing officers should lead to a healthy tax system. The new scheme of mandatory interest and additional tax should be subject to certain safeguards: (a) The Commissioner should have power in all cases to waive interest or additional tax in case of genuine hardship. The provisions of Section 273A should be suitably amended and the powers of the Commissioner in this regard strengthened. He should have full discretionary power of waiver of interest, additional tax or penalty, if any, and in prosecution cases, the power to compound or compromise, and withdraw cases; (b) There should be no automatic levy of additional tax, where the assessee has acted bona fide or where there is difference of opinion regarding assessability of income; (c) The assessees should have the right of appeal against additional tax or interest.

(e) System of Appeals

The existing system of appeals is working satisfactorily and should not be changed. Since Commissioners (Appeals) have been provided for, the institution of AACs may be abolished. Otherwise no change is necessary. The existing I.T. Appellate Tribunals, working under the jurisdiction of the Law Ministry, have been doing good work and dispensing justice to the taxpayer. The Tribunals should not be disturbed in any manner. What the government can do is to ensure that the quality of departmental representation before the tribunals is upgraded and becomes more effective.

The Chief Commissioner of Income Tax should have power under Section 264 for revision on petition by the assessee against Commissioner (Appeals)' orders. This would obviate appeals to tribunals in respect of small matters. The power of appellate Authorities to stay recovery proceeding during pendency of appeal should continue. Alternatively,it should be improvised that where the Income tax Officer does not grant stay of recovery, the Commissioner has the necessary power to stay recovery proceedings till appeals are disposed of.

The proposed scheme of establishing a high- powered appellate body under Article 323B or Entry No. 95 of List I of 7th Schedule to the constitution to be known as National Court of Direct Taxes (NCDT) , would have the effect of reducing the highest court of appeal in respect of direct taxes to the status of an administrative tribunal. Its stature, compared to the High Courts, whose functions it would take over,would be greatly diminished and the right of appeal of the assessees would be diluted. Since the Department would appoint the members of NCDT, the judges may not enjoy the same autonomy and freedom as High Court judges,which may influence their judgements.

In any case, if the Government implements the above scheme, the following safeguards are absolutely necessary; (a) There should be provision for appeal to the Supreme Court against the orders of NCDT, besides the power of the Supreme Court with regard to writs under Article 32 and special leave petitions under Article 136 of the Constitution; (b) The writ jurisdiction of the High Court should continue;(c) The NCDT should not be under the purview of the administrative ministry (Finance Ministry in this case), but under the aegis of the Law Ministry, who should have the power of appointment of judges of the NCDT; (d) The fees for filling appeals before Income Tax Appellate Tribunal (I T A T) are adequate and should not be increased.The same fee should cover identical appeals for different assessment years.

(f) Widening Tax Base and Other Suggestions

While provisions in regard to presumptive taxation needed to be vigorously implemented so as to enlarge the tax base and reduce evasion, extensive surveys were necessary to rope in self - employed traders who did not pay taxes. It should be improvised that no payment above Rs.20,000 in a year claimed as deduction from revenue, shall be made by any limited company, public undertaking or government department unless I.T.P.A.No. was produced by the supplier of any goods or services. This should automatically result in persons filing income

tax returns, and obtaining P.A.Nos. and the Department's labours to that extent would be reduced.

Besides, a large number of traders and shopkeepers do not pay income tax, although many of them pay sales - tax; list of sales tax assessess should be obtained from the sales tax departments of State Governments, and it should be ensured that they file income tax returns. The government with a view to widening the tax base has improvised a presumptive scheme of taxation for small businessmen,whereby persons in retail trade, transport *et al* whose turnover did not exceed Rs. 5 lakhs and income Rs.37000 have to pay a nominal tax of Rs.1400 per annum and they are absolved from the obligation to file tax returns. The department has made a good beginning and the scheme has great potentiality to rope in from all over India at least a million assessees.The amount of tax after achieving this target should be increased to about Rs.3000 per annum.

The Government has abolished the doctrine of 'mens rea', or guilty mind; and the onus is now on the assessee to prove that he acted bona fide. Greater care therefore is necessary to ensure that innocent people do not suffer, particularly if an offence is committed inadvertently or due to inadequate appreciation of law. Prosecution and punishment as contemplated in the Discussion Paper, should not be imposed, unless (a) assessment is completed and appeal judgements received, and (b) mala fides are proved.

Various monetary limits in regard to tax exemptions need to be revised upwards in view of the fact that owing to inflationary rise in prices during the last few decades, the real value of such limits has declined. For instance, the basic exemption limit for income tax may be increased to Rs. 60,000 and the initial exemption in respect of long - term capital gains should be increased to Rs.20,000. The qualifying amount of investment in prescribed channels for tax rebate under section 88 should be increased to Rs. one lakh. The limit of exempt allowance in respect of dividends and unit income under section 80L should be

enhanced to Rs.25,000 from Rs.13,000; these measures would stimulate savings.

Concessions have been built into the tax structure in order to promote various extraneous objectives, such as promoting development of backward areas, stimulating exports, earning foreign exchange , promoting charities, and providing incentives for family planning and for rural development . These concessions have many conditions attached to them, which adds to the complexity of tax laws. If the Government desires to promote other objectives, it should evolve separate incentive schemes for encouraging them.It would be advisable to delete some of these provisions from tax laws, while reducing the effective tax rates, which would result in lesser evasion and avoidance. Besides, incentives should not be hedged by various procedural and other conditionalities, making it difficult for assessees to claim them.Whatever may be the quantum of allowances, the scheme should be simple and definite, and there should be no room for exercise of discretion by the officer to disallow it.

7.9 Scheme for Disclosure and Utilization of Unaccounted Money

While estimates of unaccounted money circulating in the economy vary widely, it is indisputable that there are large hoards of black money, and the generation of such money is also taking place. Various efforts have been made from time to time in the form of disclosure schemes, capital bonds, demonetization and of course, raids, to discover and bring it into the net of taxation, but the success achieved so far is only marginal.

It is now increasingly recognized that low rates of taxation, simplification of tax structure and placing some trust in the taxpayer provide the best method of dealing with this problem. These are combined with deterrent punishment for evasion. The carrot and stick policy has definitely resulted in making the cost of evasion high, while the net benefit from evasion has been reduced, consequent upon which the level of generation of black money has somewhat declined. But the problem of bringing out black money into legitimate circulation and its

utilization for industrial development and other nation building activities, is far from resolved. The problem is indeed difficult; however, it may be worthwhile to devise a simple scheme, whereby such money could be disclosed and constructively utilized.

The basic difficulty arises that if the maximum marginal rate of tax is 40%, it would be inequitable and unethical to charge a lower rate of tax on black money disclosed. In a complete restructuring of tax rates, the maximum marginal rate of tax should be brought down to 30%. The trend in developing countries, particularly East Asian countries is towards reducing the maximum marginal rate of tax to about 30 per cent (Vide Table 7.5) Such a move would encourage voluntary compliance of tax laws and reduce creation of black money.

If the above proposal is implemented, a simple scheme could be formulated. It may be provided that an assessee could at any time during the year credit unaccounted money in his books, subject to the following conditions:

(1) He simultaneously informs the ITO by a notice in the prescribed form that he has credited such money in his books of accounts and has deposited 70% thereof in his bank account.

(2) He pays 30% of the amount credited in the books in the form of tax into the Reserve Bank of India or authorized banks to the credit of the Government account, through a challan obtained from the Income Tax Department, within a period of seven days, and forthwith deposits the receipted challan of tax with the ITO.

(3) He intimates to the ITO that such money less tax would be utilized by him within a period of six months in the purchase of one or more of the following assets:

(a) Plant and Machinery

(b) Shares of New Companies

(c) National Savings Certificates

(d) Unit Trust Scheme Certificates

(e) New Flat or House

(4) Such assets shall be held by the assessee for a minimum period of three years.

(5) If he fails to invest the money in any of the approved channels, he shall be liable to pay an additional penal tax at 25% of the gross amount disclosed and credited in the books.

The advantage of the scheme to the assessee is in its simplicity, and he does not have to bother about payment of penalty or interest. He does not also have to explain the source of money or reply to questions of authorities. Besides, he is able to utilize the unaccounted money either in his business, in housing or for purchase of shares, units or saving certificates, which are productive of income.

The inestimable benefit of the scheme, from the point of view of revenue, would be that the parallel economy would be reduced and black money channelized into nation building activities, rather than be spent on consumption or investment in undesirable channels, leading to inflation. The assets created and incomes generated would be subject to wealth-tax and income tax, and would be productive of revenue.

7.10 Tax Reforms Committee Report and Its Implementation

Tax reform in India was essentially based upon the recommendations of the Tax Reforms Committee (Chelliah Committee), which on the whole had done a commendable job. Planning and execution of tax reform was both an art and a science and in recognition of this important dictum, pragmatism, rather than theoretical considerations, had been the guiding spirit of the Committee in formulating its recommendations. The criteria for evaluating tax reform in a developing country, would be whether (a) it subserved the objectives of the

Government, particularly in regard to meeting revenue needs of the state, augmenting savings and investment, and being conducive to accelerating the momentum of growth; (b) it was in tune with the economic and political ethos, aspirations and environment in the country; (c) it would facilitate globalization of the economy and contribute to international harmonization of the tax structure; and (d) it was capable of implementation and effectuating improvement in tax administration in the country. The Chelliah Committee Report broadly appeared to meet these requirements. The Chelliah Committee closely followed the World Bank model. Commending the Report, Bird[18] stated that it should 'improve policy outcomes in India'. The Report had been essentially accepted by the Government, although only time would show how far it is implemented and whether it would succeed in improving tax administration in the country.

The Finance Minister's tax reforms were as bold and judicious as his liberalization measures; also they were equally effective in moving several steps ahead towards the avowed goals. The *Discussion Paper* stated that India had to move to a tax system which was simple, had a wide base with moderate rates of tax, was well-administered and, most important, promoted economic efficiency, growth and equity. The perceptible reduction in taxes – both personal and corporate – should provide incentives for industrial expansion and better voluntary tax compliance.

The Finance Minister in consonance with the present fiscal world environment had accepted the modern thesis that where a country's tax structure was heavy, situated on the right side of the parabola on a graph with taxes represented on the horizontal axis and revenues on the vertical axis, diminution in taxes led to buoyancy in revenues on account of stimulated activity and increased work, production and incomes, together with reduced evasion and avoidance. Actually, the ball was in the taxpayer's court, and if personal tax revenues despite reduced rates maintained buoyancy – as during the financial year 1993-94 when income-

tax revenues exceeded the target – the Finance Minister may be induced to further simplify and rationalize taxes, as the triple benefit formula became effective: taxpayers were responsively happy, revenues acquired buoyancy and the momentum of growth was accelerated. Innovative tax policies needed to be further pursued in order to arrive at the optimal marginal tax rate at which revenues were maximised, and alignment with international tax levels achieved. The Government in tune with Chelliah Committee's Report, reduced personal and corporate taxes; the beneficial effect had been electrifying and buoyancy in revenues during the fiscal year 1994-95 was such that direct tax collections greatly exceeded targets. This buoyancy we are confident would be sustained in the years to come.

Table 7.1

Growth of Central Taxes (by Major Heads)

(Rs. crore)

		1990-91	1991-92	1992-93	1993-94	1994-95 (RE)	1995-96 (BE)
1.	Corporation Tax	5335	7853	8899	10060	13250	15500
2.	Income Tax	5371	6731	7888	9115	11000	13500
3.	Customs	20644	22257	23776	22193	26450	29500
4.	Union Excise Duties	24514	28110	30832	31697	36900	42780
5.	Other Central Taxes of which	594	1145	1727	1481	2040	2281
	• Wealth Tax	231	307	468	154	80	90
	• Gift Tax	3	8	9	5	14	10
	• Other Taxes & Duties	360	830	1250	1322	1946	2181
6.	Taxes of Union Territories	1118	1265	1515	1198	191	201
7.	Gross Tax Revenue	57576	67361	74637	75744	89831	103762
8.	Less States' Share	14598	17292	20593	22295	24843	29388
9.	Net Centre's Tax Revenue	42978	50069	54044	53449	64988	74374
10.	Non-Tax Revenue	11976	15962	20084	22004	23782	26413
11.	Total Revenue	54954	66031	74128	75453	88770	100787

Source : Budget Papers, various years, Ministry of Finance, G O I.

Table 7.2

Percentage Share in Tax Revenue

	1990-91	1991-92	1992-93	1993-94	1994-95 (RE)	1995-96 (BE)
1. Corporation Tax	9.3	11.7	11.9	13.3	14.7	14.9
2. Income Tax	9.3	10.0	10.6	12.0	12.2	13.0
3. Customs	35.9	33.0	31.9	29.3	29.4	28.4
4. Union Excise Duties	42.6	41.7	41.3	41.8	41.1	41.2
5. Other Central Taxes	0.9	1.7	2.3	2.0	2.3	2.2
• Wealth Tax	0.4	0.5	0.0	0.2	0.1	0.1
• Gift Tax (1987 Act)	Neg.	Neg.	Neg.	Neg.	Neg.	Neg.
• Other Taxes & Duties.	0.5	1.2	1.7	1.8	2.2	2.1
6. Taxes of Union Territories	2.0	1.9	2.1	1.6	0.2	0.2
	100.0	100.0	100.0	100.0	100.0	100.0

Neg = Negligible

Source : Budget Papers, various years, Ministry of Finance, G O I.

Table 7.3 A

Centre's Receipts and Expenditure

(Rs. crore)

		1980-81	1990-91	1991-92	1992-93	1993-94	1994-95 (BE)	1995-96 (BE)
1.	Revenue receipts (2+3)	12419	54954	66031	74128	75453	88770	100787
2.	Tax Revenue (Net of States share)	9358	42978	50069	54044	53449	64987	74374
3.	Non-Tax Revenue	3061	11976	15962	20084	22004	23783	26413
4.	Revenue Expenditure of Which	14455	73516	82292	92702	108169	122902	136328
	(a) Interest Payments	2604	21498	26596	31075	36741	44000	52000
	(b) Subsidies	1851	12158	12253	11995	12864	12810	12401
	(c) Defence Expenditure	3604	10874	11442	12109	14978	16611	18146
5.	Revenue deficit	2037	18562	16261	18574	32716	34132	35541
6.	Capital Receipts	7261	38997	38528	36178	55540	67502	66364
	(a) Recovery of Loans	2104	5712	6021	6356	6191	6700	6730
	(b) Other receipts			3038	1961	– 48	5767	7000
7.	Capital expenditure	7801	31782	29121	29916	33684	39370	35823
8.	Total expenditure of which	22256	105298	111413	122618	141853	162272	172151
	(a) Plan expenditure	8994	28365	30961	36660	42855	48761	48500
	(b) Non-Plan expenditure	13262	76933	80452	85958	98998	113511	123651
9.	Fiscal Deficit	7733	44632	36323	40173	60257	61035	57634

Source : *Economic Survey 1995-96*, G O I, New Delhi, p 18.

Table 7.3 B

Centre's Receipts and Expenditure
(Per Cent of G D P)

		1980-81	1990-91	1991-92	1992-93	1993-94	1994-95 (R E)	1994-95 (B E)
1.	Revenue receipts (2+3)	9.1	10.3	10.7	10.5	9.4	9.4	9.6
2.	Tax Revenue (Net of States share)	6.9	8.0	8.1	7.7	6.7	6.9	7.1
3.	Non-Tax Revenue	2.3	2.2	2.6	2.8	2.7	2.5	2.5
4.	Revenue Expenditure of Which	10.6	13.7	13.3	13.1	13.5	13.0	13.0
	(a) Interest Payments	1.9	4.0	4.3	4.4	4.6	4.7	5.0
	(b) Subsidies	1.4	2.3	2.0	1.7	1.6	1.4	1.2
	(c) Defence Expenditure	2.6	2.0	1.9	1.7	1.9	1.8	1.7
5.	Revenue deficit	1.5	3.5	2.6	2.6	4.1	3.6	3.4
6.	Capital Receipts	5.3	7.3	6.2	5.1	6.9	7.1	6.3
	(a) Recovery of Loans	1.5	1.1	1.0	0.9	0.8	0.7	0.6
	(b) Other receipts	0.0	0.0	0.5	0.3	0.0	0.6	0.7
7.	Capital expenditure	5.7	5.9	4.7	4.2	4.2	4.2	3.4
8.	Total expenditure of which	16.4	19.7	18.1	17.4	17.7	17.2	16.5
	(a) Plan expenditure	6.6	5.3	5.0	5.2	5.3	5.2	4.6
	(b) Non-Plan expenditure	9.8	14.4	13.0	12.2	12.4	12.0	11.8
9.	Fiscal Deficit	5.7	8.3	5.9	5.7	7.5	6.5	5.5

Source : *Economic Survey 1994-95*, G O I, New Delhi p. 15.

Table 7.4

Direct and Indirect Tax Revenues of the Centre and States.

(Rs. crore & per cent)

(Rupees Crore)

Year		Centre (Gross)			States			Centre and States Combined		
		Direct	Indirect	Total	Direct	Indirect	Total	Direct	Indirect	Total
1980-81		2,907	10,242	13,149	686	5,929	6,615	3,593	16,171	19,764
	(a)	22.1	77.9	100.0	10.4	89.6	100.0	18.2	81.8	100.0
	(b)	2.1	7.6	9.7	0.5	4.4	4.9	2.6	11.9	14.5
1990-91		11,024	46,489	57,513	3,244	26,804	30,048	14,268	73,293	87,561
	(a)	19.2	80.8	100.0	10.8	89.2	100.0	16.3	83.7	100.0
	(b)	2.1	8.8	10.9	0.6	5.1	5.7	2.7	13.8	16.5
1994-95 (BE)		24,790	62,346	87,136	5,032	47,831	52,863	29,822	1,10,177	1,39,999
	(a)	28.4	71.6	100.0	9.5	90.5	100.0	21.3	78.7	100.0
	(b)	2.7	6.8	9.5	0.6	5.2	5.8	3.3	12.0	15.3

(a) : Represents percentages to total tax revenue.

(b) : Indicates tax to G D P ratio in percentages; for 1994-95 percentages have been worked out on the basis of the implicit nominal G D P underlying the Budget estimate of G F D/G D P ratio of 6.0 per cent for 1994-95.

Source : Budget Documents of Government of India and State Governments. R B I Annual Report 1993-94 p. 196.

Table 7.5

Maximum Personal Income Tax Rates in East Asian Countries and India in 1994

South Korea	45
Taiwan	40
India	40
Thailand	37
Indonesia	35
Malaysia	32
Singapore	30
Hong Kong	20

Source : Worldwide Tax Guide, Pannell Kerr Forster, P K F Worldwide, Melbourne, 1995, Various pages.

Note : Maximum Personal Income Tax Rate in India in 1972-74 was 97.75 per cent.

Maximum Tax Rate for India in the Table relates to 1995.

Chapter 7 References

1. Ludwig Erhardt, *Prosperity through Competition*. Thames & Hudson,London, 1958, p. xii.
2. *Taxation Enquiry Commission Report*, G O I, New Delhi 1955, Vol 1, p 154.
3. Meade Committee Report (U.K.) *The Structure and Reform of Direct Taxation*. Report of Committee, Chairman J. E. Meade, 1978, George Allen & Unwin, London, p 18.
4. Adam Smith, *The Wealth of Nations*, 1976, ed Edwin Canon, The Modern Library, New York, pp 777 - 9.
5. R. J. Chelliah, *Fiscal Policy in Underdeveloped Countries*. George Allen & Unwin, London, 1960, p 66.
6. Japanese Tax Commission (cited by Tax Bureau), *An Outline of Japanese Taxes 1980*. Tax Bureau, Ministry of Finance, Tokyo, Japan, p 19.
7. Nicholas Kaldor, *Indian Tax Reform - Report of a Survey*, Ministry of Finance, Delhi, 1956, various chapters.
8. R. J. Chelliah (Vide Note 5 above) p 138.
9. Keith Marsden *World Bank Study, Finance and Development* I M F and World Bank, New York, Sept. 1983, p 40.
10. Cited by Richard 1. Kirkland Jun., US Cuts Go Global *Fortune*, 24 Nov, 1986, p 132
11. *Direct Taxes Laws Committee* (Choksi Committee) *Final Report* Part I, 1978, Ministry of Finance, Government of India, New Delhi, p 16.

12. *Asian Development Outlook 1993*, Asian Development Bank, Manila, Oxford Univeristy Press, Hong Kong, p 27.

13. K. S. Mehta, Taxes and Entrepreneurs, *Economic Times*, New Delhi, 28 November, 1994.

14. *Tax Reforms Committee* Chaired by R. J. Chelliah (Chelliah Committee) Final Report Part I, Ministry of Finance, Government of India, New Delhi, 1993, p 15.

15. C. H. Hanumantha Rao, Agriculture : Policy and Performance, in *The Indian Economy* Ed. Bimal Jalan, Viking Penguin Books India Pvt. Ltd., New Delhi 1992, p 132.

16. Discussion Paper on *Simplification and Rationalization of Direct Tax Laws*. Ministry of Finance, Government of India, New Delhi 1986, p 1.

17. Chelliah Committee Report (Vide Note 14 above) p 66.

18. Richard M. Bird, Tax Reform in India, *Economic and Political Weekly*, New Delhi, 11 December 1993 Issue, p 2721.