# CHAPTER II

## DIRECT TAXATION AND ECONOMIC DEVELOPMENT

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## 2:1 ROLE OF DIRECT TAXATION IN ECONOMIC DEVELOPMENT :

The state which is essentially the 'Wealfair state' is assuming an important role in the process of economic development of less developed countries. This role is not only directional or regulatory but is more positive in a sences that the state it self has assume responsibility of planned development. Being an ingredient of the fiscal policy, the tax policy is an important instrument for accelerating the tempo of economic development in L.D.Cs.

Almost all the developed countries of the world today place much reliance on direct taxes as a means of generating saving and promoting capital formation. However, direct taxes did not dominate the tax structure of developed countries in the initial stages of economic development. Even today, the tax structure in of L.D.Cs characterised by the small proporation of revenue by direct taxes. This doesnot mean that direct taxation is after all of minor significance in L.D.Cs. Indirect taxes are, of course, of major importance in such countries in the short period but "fiscal policy has to aim at creating a climate, which will allow an ampler-use of direct taxes in long run"[1].

In less developed countries, as development proceeds ahead, direct taxes should gradually come into force.

Direct taxes are capable of imparting built-in-flexibility in tax structure of L.D.Cs. In L.D.Cs, taxes should be chosen in such a manner that the state will be able to collect larger and larger revenue as the national income goes up. The only suitable tax for this propose is the prograssive direct tax. In L.D.Cs economic development raises per capita income and if progressive direct taxes are used, those who were paying taxes earlier would pay more taxes and some of those who were below the exempation limit would start to pay taxes. Thus direct taxes contain within themselves the element of built-in-flexibility for giving government larger revenues from growth without even changing the level of taxation. While advocating Philip pointed out that "there is a wide range of possibility in which the glamour woven round. Progressive direct taxation may still hold good"[2].

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1. HNPS Suman, Direct Taxation and Economic growth in India. Sterling Publishers Pvt.Ltd., (1974), P. 24
2. Ibid - P. 25

Thus it may be said that in LDCs their is sufficient scope for using direct taxes in prograssive fashion.

Again, direct taxes are most powerful instruments in the fiscal armoury to narrow the gap between available incomes of the rich and the poor. In L.D.Cs better distribution of income also possible through using direct taxes in progressive fashion.

The maintenance of monetary stability constitutes an additional argument in favour of direct taxation. The progressive direct tax system provides government with a built-in protection against inflation. When money incomes increase with rise in prices the progressive direct tax system causes government revenues to increase atleast per person with national income and more rapidly if the system is sufficiently progressive. Thus progressive direct taxes viz - income, wealth and Gift are powerful check on an inflationary expansation of money incomes.

## 2:2 DIRECT TAX TRENDS IN DEVELOPED AND LESS DEVELOPED COUNTRIES :

The tax system in almost all developing countries, is characterised by the small proportion of revenue by direct taxation. On the contrary, direct taxes as percentage of total tax revenue occupy significant importance in the tax structure of developed nations. The following table showing the direct taxes playing important role in developed countries as compared to L.D.Cs.

TABLE 2:1 :- DIRECT TAX REVENUE AS PERCENTAGE TO TOTAL TAX REVENUE IN DEVELOPED AND LESS DEVELOPED COUNTRIES.(for the year 1962-63)

| Developed Countries | Direct tax revenue as % to total tax revenue. | Less developed countries | Direct tax revenue as percentage to total tax revenue. |
|---|---|---|---|
| U.K. | 47.9 | Cylon | 25.0 |
| Austrelia | 58.5 | Brahma | 24.0 |
| West Germany | 57.4 | Pakistan | 28.2 |
| U.S.A. | 60.8 | India | 29.6 |
| Canada | 63.0 | Maxico | 36.03 |
| Japan | 53.8 | Philipines | 28.03 |
| Average | 56.82 | - | 28.56 |

Source : SNPS Suman, Direct taxation & economic growth in India, Sterling Publishers Pvt.Ltd.,1974, P - 14.

The table shows that the average percentage of direct tax revenue to total tax revenue in developed country is 56.82 whereas in the L.D.Cs, it is only 28.56. This reveals that direct tax contribution to total revenue of developed country is almost double as compared to L.D.Cs. The greater reliance on direct taxes in developed economy as compared to L.D.Cs, is due to a higher level of per capita income, larger percentage of direct taxes to national income. While pointing out the real cause of lesser use of direct taxes in tax structure of less developed country, Dr. Richard gives conditions for the successful use of taxation which are not found in L.D.Cs., these conditions are as below[1]:

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1. Ibid, P. 17.

a) The existance of predominatly money economy.

b) A high standard of literacy among tax payers.

c) Prevalance of accounting record honestly and reliably maintained.

d) Large degree of voluntary compliance on the part of the tax payers.

e) Healthy political condition.

f) Honest and efficient tax administration.

Besides these conditions almost all L.D.Cs characterise by agriculture income and such income is neglected from revenue of most of nations due to real assessment of agriculture income is very difficult task as well as condition prevailing like political power of nations. Thus most of the L.D.Cs. failed to make ample use of direct taxation in their tax structure.

Another reasons for low coverage of direct taxes in L.D.C. is that the tax structure of most of the developing countries, we find the pre-dominance of indirect taxes. The Govt. in a developing country looks towards the indirect taxes as an important source of revenue since it has got necessary elasticity to meet the needs of development finance.

The method of raising revenue in short period viz.indirect taxes is very convenient in these countries. Due to following reasons, L.D.Cs prefer indirect taxes over direct taxes :

a) The books and records of business are not found proper maintained in L.D.Cs.

b) Indirect taxes hidden in the price of goods and hence their psychological effect will be favourable because people do not know how much taxes are included in the prices of goods.

c) Per capita income of these nations is very low and most of people below the exemption limit. Therefore there is no sufficient scope for direct taxes.

d) The prospassity to consume of people in these countries are very high and there is necessary to cartailment of current consumption for the purpose of investment.

e) Indirect taxes stimulate production and consumption and they also check the level of production.

f) Indirect taxes are also anti-inflationary in less developed countries and stabilise prices and increase employment.

The above discussion indicate that although indirect taxes should form the basis of tax policy in the initial stages of economic development of L.D.Cs, the direct taxes can also play an important role in this regard.

## 2:3 TAX ADMINISTRATION IN THE CONTEXT OF DEVELOPING COUNTRIES :

The policy of developing countries is being generally directed to obtaining increased revenue to finance their development plans. For this purpose they search for new sources of revenue but it is possible through improvement in tax machinery. All developing countries intend to raise their tax rates but it should be understood that feasible tax efforts is necessary which depends primarily on two factors :-

1) Firstly, existance of tax handles and
2) Secondly, willingness of population to be taxes.

The existence of tax handles depends on capability of the tax administration.

### PRE-REQUISTTS FOR TAX ADMINISTRATION :

Before a country consider to administer its tax system in best possible way, it must have clear picture of the scope of that system. In order to get this picture codification of tax law serves as a pre-requisite. Besides this some of the basic aspects must be considered from the administrative point of view. These are :-

a) Ascertainment of tax payers.

b) Obtaining voluntary compliance.

c) Audit and investigation of returns.

d) Efficiency and cost of collection of taxes.

e) Adequate penalty provisions.

f) Overall management.

These basic aspects of tax administration usually do not found in L.D.Cs. This may result in tax payments which are either under payments or over payments. In this connection Colombia Commission on tax reform observes that " taxes no matter how well meaning the statutes enacting them, are no better than the quality of their administration. Improved administration, therefore, is an important aspect of tax reform. Yet it cannot be denied that this problem has not received adequate attention in developing countries"[1].

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1. S. K. Singh, Public Finance in Developed and Developing Countries, S Chand & Co.Pvt.Ltd. - New Dehli, 1982, P. 249

At present movement in all developing countries progressive income based taxes are steadily growing. But these taxes require efficient administration. Among the all forms of direct taxes, " income tax may well be the fevourite of the 20th Century but it demands 20th century administration"[1].

To conclude, we may say that in the tax structure of developing countries, there is sufficient room for tapping direct-taxes. As a corollary to this,there is a need for complete overhauling of tax administrative which will make the tool of direct taxation more effective-serving the needs of development.

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1. Ibide , P. 250.