CHAPTER III

DIRECT TAXATION IN INDIAN TAX SYSTEM

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3:1 REVIEW OF INDIAN TAX SYSTEM :

India being oldest civilization of the world, had well developed system of public finance since very early age. Taxation is well recognised as an instrument of public finance and administration in almost all literature including the Hindu Dharmashastra. During Mouryan period taxation was used to meeting the expenses of administration. In these days important levies approved by Koutilya were land tax, taxation on house in cities, duties on sale of goods, taxes on income of persons engaged in profession other than agriculture.[1]

Before independence Government of India act 1935 was land mark in financial system of Government. The said act was the first step towards the provincial AUTONOMY and the division of financial power as between the Union and State. The financial resources relating to taxes were grouped into four categories :-

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1. Vinay Kumar : Tax System in India and Role of Income Tax, Deep and Deep Pub., New Delhi, 1988, P. 25.

1. Exclusively federal resources,
2. Exclusively provincial resources,
3. Certain taxes which are to be shared by the Union and by the States,
4. Taxes levied and collected by the Union but devoted to the States.

After independence, Government of India took up major task of planned economic development. The financial resources required for this planned development were raised through number of means besides taxation. In the Indian tax system, both the Central and the State Governments are empowered to levy taxes - but the subjects of taxation are clearly demarcated in the constitution of India. This refers to both i.e. direct taxes and indirect taxes. Naturally there are constraints arising out of constitutional provisions as to what items are to be taxed by the Union Government. Hence it requires thorough examination of the position of direct taxes in the Indian tax system.

The following sources of tax revenue are contained in Union list :-

1. Taxes on income other than agriculture income, (Entry - 82),
2. Duties on customs including export duty, (Entry - 83),
3. Duties on excise on goods manufactured, (Entry - 84),
4. Corporation tax or Company's taxation, (Entry - 85),
5. Taxes on capital value of the asset, (Entry - 86),
6. Estate Duty (Entry - 85),
7. Duties in respect of succession to property other than agriculture land (Entry - 88),
8. Taxes on railway fare and freights (Entry - 89),
9. Taxes on transactions in stock exchange of foreign market (Entry - 90),
10. Stamp duties (Entry - 91),
11. Taxes on sale or purchase of newspapers and on advertisement published therein (Entry - 92),
12. Taxes on sale or purchase of goods other than newspapers (Entry - 92A),
13. Fees in respect of any of the matter in the list, but not including fees taken in any Court (Entry - 96).

With the evergrowing requirement of revenue, the State Governments have also extensively used their taxing power for mobilising additional resources. These sources of tax revenue for the State Government are contained in list II of the Seventh Schedule of the constitution of India. These are as follows:

1. Land revenue (Entry - 45),
2. Taxes on Agricultural income (Entry - 46),
3. Duties in respect of succession of agricultural land (Entry - 47),
4. Estate duty in respect of Agricultural land (Entry - 48),
5. Taxes on land and Buildings (Entry - 49),
6. Duties of Excise on Alcoholic liquors for human consumption (Entry - 51),
7. Taxes on Entry of Goods into a Local area for consumption use or sale therein (Entry - 52),
8. Taxes on consumption and sale of Electricity (Entry - 53),
9. Taxes on the sale or purchase of goods other than newspapers excluding inter-state sales (Entry - 54)
10. Taxes on advertisements other than these published in newspapers (Entry - 55),

11. Taxes on goods and passengers carried by road or on inland waterways (Entry - 56),
12. Taxes on vehicles for use on roads (Entry - 57),
13. Taxes on animals and boats (Entry - 58),
14. Tools (Entry - 59),
15. Taxes on professions, trades, callings and employments (Entry - 60),
16. Capitation taxes (Entry - 61),
17. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling (Entry - 62),
18. Rates of Stamp Duty in respect of documents other than those subject to stamp duty by the Government of India (Entry - 63),
19. Fees in respect of any of the matters in the State list, but excluding court fees (Entry - 66),
20. Fees taken in all courts except supreme Court (Entry - 3),
21. Share in some specified Union taxes.

3:2 DIRECT TAX TRENDS IN TAX STRUCTURE :

Indian tax structure is broadly divided into direct and indirect taxes. Direct taxes include personal

TABLE 3:1 :- COMPOSITION OF TAX REVENUE OF GOVERNMENT OF INDIA.*

(Rs. in crores).

Year	Tax Revenue			Direct tax	Indirect tax	Total tax revenue as % of G.D.P.
	Direct	Indirect	Total	as % of total tax revenue		
1950-51	230	397	627	36.6	63.40	6.86
1960-61	420	1040	1460	28.08	71.02	9.07
1970-71	1091	3864	4955	22.00	78.00	12.3
1980-81	3575	16746	20321	17.06	82.04	15.0
1983-84	5335	26471	31826	16.08	83.02	15.04
1984-85	5806	30640	36446	15.09	84.1	15.9
1985-86	6544	37028	43572	15.0	85.0	16.6
1986-87	7366	42789	50165	14.7	85.3	17.1
1987-88	8164	48914	57078	14.03	85.7	17.3

* Union State and Local Government combined.

Source : Stastical outline of India, Published by Tata Services Pvt.Ltd., 88-89, P- 159.

direct taxes corporate taxes, wealth tax, estate duty. Direct taxes of state and local bodies include taxes on agricultural income, land revenue and taxes on buildings etc. Indirect taxes of the central government include taxes on capital transaction, taxes on advertisement, custom duties, excise duty. Indirect taxes on state and local bodies include sales tax, certain excise duties entertainment tax, taxation of motor vehicle, registration and stamp duties.

The trends in tax revenue of Central Government State Government and local bodies between 1950-51 and 1987-88 have been shown in Table No.3.1

It makes clear from the above table that total tax revenue as proportion to G.D.P. have been increased during the period. In 1950-51 tax revenue constituted only 6.8% as % of GDP, was increased upto 17.3% in 1987-88. This means it become doubled. The table also reveals that the percentage of direct tax revenue to total tax revenue has been continuously declining. However, percentage of indirect taxes is steadily increasing from 63.4% in 1950-51 to 85.7% in 1987-88. This clearly throws light on the increasing importance of indirect taxes in the tax system of India. Along with its increased contribution we notice that the contribution of direct taxes is falling drastically. This picture supports our main contention that sources of direct taxes are not being exhausted systematically for want of adequate and reasobale levelof tax administration in India.

3:3 STRUCTURE OF DIRECT TAXATION IN INDIAN TAX SYSTEM :

Direct taxes in its modern form in India has levied for the first time in 1860, in the form of tax on income.[1] The main object of this levy was raising revenue for the govt. After independence, direct taxes has come to acquire an important place because of change in socio economic and political conditions.

In early stage of economic development government mostly relying on source of indirect taxes. However in long run of development, the increasing share of direct taxes also equally important because they are more equitable, administratively efficient and related to individual ability to pay. Most of nations in world have possessed form of progressive personal taxation and other direct taxes since they are more equitable as compared to indirect taxes.

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1. Ibid - Preface.

The structure of direct taxes in India has undergone fundamental change since independence, especially in accordance with the recommendation of the Taxation Enquiry Committee (1953-54) and Kaldor's report on Indian Tax Reform (1956). New taxes were introduced for strengthening integrated direct tax structure.

A brief explanation of important direct tax levies in India is given as follows :

A) **INCOME TAX** :

Income tax was introduced in India in 1860 with a view to overcome financial difficulties of the treasury. Initially it was only a temporary measure of raising revenue for the government. The constitution empowered Central government to levy and collect taxes on income other than agriculture. The present scheme of taxation of income operates through the income tax Act,1961. The tax is payable by natural as well as artificial persons, on their income of privious year. Although the income tax collection is increased during planning period its share in Govt. tax revenue is declined because of low coverage, large number of exemptions and deductions, increased collection from other taxes and partly because of large scale evasion and avoidance. This has been clear from Table 3·2.

TABLE NO.3:2 :- COMPOSITION OF DIRECT TAX REVENUE OF CENTRAL GOVERNMENT*

(Rs. in crores)

Year	Total Direct tax	Income tax	Corporation tax	Estate Duty	Wealth tax	Gift tax	Other direct taxes.
1950-51	177 (100)	133 (75)	40 (23)	-	-	-	4.0 (2)
1960-61	295 (100)	168 (57)	111 (38)	3.1 (1)	8.1 (2.7)	0.9 (0.3)	3.9 (1)
1970-71	877 (100)	473 (54)	370 (42)	7.9 (0.9)	15.3 (2)	2.4 (0.2)	8.4 (0.9)
1980-81	3010 (100)	1506 (50)	1310 (44)	16.3 (0.5)	67.4 (2)	6.5 (0.2)	103.8 (3.3)
1985-86	5640 (100)	2509 (45)	2865 (50)	22.2 (0.5)	153.4 (2.8)	11.7 (0.2)	78.7 (1 5)
1988-89	7740 (100)	3450 (44)	4050 (53)	3.3 (0.04)	120.0 (1.56)	10.0 (0.1)	106.7 (1.3)

* Inclusive of State share in Income Tax and Estate Duty.

Note : Figures in bracket indicate percentage.

Source : Report on currency & finance 1959-60, 83-84, RBI Bulletin 1985.

Budget documents 1988-89.

Quoted from "India economic information year Book" 88-89. National publication House New-Delhi,(Ed) by A.N.Agarwal et.al.

B) CORPORATION TAX :

"A company is subject to both what we call an income tax and corporation tax which is named as super tax"[1]. corporation tax is the most important source among all the direct taxes. This tax operates under the provision of the Income Tax Act,1961. Changes have been made from time to time in structure of Corporation Tax so as to provide increasing revenue to development plans and also to achieve economic objectives of growth and production. The result is that now we have quite complicated structure of corporation tax, exemptions and concessions very and related to different activities, criteria and types of corporate income, investment and like. For example - development rebate was introduced in 1955 in place of an initial depreciation allowance. Another incentive provided for growth of corporate sector in India is the tax holidays which was introduced in 1957-58. The export based industries also give incentives and concession. Now recent years of development the place of corporation tax in tax

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1. H. L. Bhatia : 'Public Finance' Vikas Publishing House Pvt. Ltd. 1979, P - 420.

revenue is significant. It make clear from table 3:2 That corporation tax shows increasing trends as compared to other direct taxes.

C) **WEALTH TAX :**

In view of the recommendations for an integrated direct tax system made by Nicholas Kaldor, a tax on wealth was levied in India under the Wealth Tax Act,1957.[1] Initially the wealth tax was levied on the net wealth of an individual and HUF and also company. The tax on companies has however been discontinued from the assessment year 1960-61.

Agricultural land, building, excludes from the purview of wealth tax with effect from April, 1981. Presently this tax is levied especially on capital value of assets other than agriculture. The contribution of wealth tax is insignficant during the planning period. This becomes clear from table No.3·2.

D) **GIFT TAX:**

Gift tax emerged in our tax system since, the recommendation of Kaldor who rightly opined "There is no

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1. Vinay Kumar : Opcit P.41

reason in equity for differenciating between the right to pass on property through gifts and the rights to pass on property by, bequests"[1]. Consequently gift tax was levied in India with effect from first April, 1958. Gift tax was levied on progressive scale with the provision of exemption limit. This tax is payable by donee. However, revenue importance of Gift tax is not very significant. It is clear from table No.3·2.

E) **ESTATE DUTY :**

The levy of estate duty in India was recommended as early as in 1924 by Indian Taxation Enquiry Committee but actually it was included in 1953 after passing Estate Duty Tax Act of 1953.

Under the Indian constitution Estate duty is union levy, however whole proceeds of which are transferred to State. From this point of view, it hardly contributes directly in the resource mobilisation efforts of the Union Govt. This levy was in operation for over 30 years. Its contribution even to state resources is quite nigligible. Hence estate duty has been abolished with effect from 16th March, 1985, and estates passing after this date is not

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1. Ibid - P. 42.

subjected to tax. Contribution of estate duty to Govt. revenue is very poor during planning process. This is evident from table 3·2.

F) **LAND REVENUE :**

Land revenue, the most important direct tax levied and collected by States; it is imposed on all agriculturists. Land revenue took important place in State Taxation in early phase of development. However the relative importance of this Tax was continuously declined in recent time due to low rates, absence of element of progression and the tax base bearing no definite relation with the yield or income from land. The contribution of land revenue to states own tax revenue was almost insignificant. It is evident from the Table No. 3·3.

G) **AGRICULTURE INCOME TAX :**

A tax on the agriculture income was initially imposed under the Income tax Act of 1860, but when the Act of 1886 came into force agriculture income was kept outside the perview of income taxation. The Govt. of India Act 1935 empowered to the State Govt. to impose Tax on agriculture, however, at present number of State

ENUE

(Rs. in crores)

Year	5 as % of 2
1	6
1960-6	24.11
1965-6	14.47
1970-7	8.06
1975-7	7.28
1976-7	5.39
1977-7	5.24
1978-7	5.40
1979-8	3.71
1980-8	2.90
1981-8	2.94
1982-8	2.33
1983-8	2.63
1984-8	2.98
1985-8	2.78
1986-8	2.38

Note :

Source

Govts. are still reluctant in levieing this Tax. In India the rates of agricultural Income tax, are lower and differ from State to State. High exemption limit has also been provided. Besides this improper accounting in agricultural sector also came into effective use of agricultural income tax. Therefore the contribution of this Tax to States tax revenue is quite insignificant. This has shown in Table No.3.3.

3:4 ADMINISTRATIVE INEFFICIENCY :

The attainment of clean, efficient and honest tax administration was serious problem facing the tax structure today in India. A good tax administration is the single variable which can go along way to agument the resources of the State and bring about social justice in taxation. It is a fact that like justice, tax administration must not only be good but should be recognised and accepted as good. In words of Working Group on Central Direct Tax Administration of Administrative Reform Commission, If tax system is functioning properly, there should be[1]—

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1. Report of the Working Group on Central Direct Taxes Administration, Manager of Publication, 1968, P. 6.

a) No arrears of assessment at the end of the tax years

b) No arrears of tax demands at the tax years,

c) Every item of tax evasion would be promptly and properly dealth with.

d) A sense of faith on the part of the tax paying public in the tax Administration and,

e) Absence of sense of irritation and harrassement created by the burdonsome procedure.

According to the Committee these factors are present, it will be an ideal state of affairs. Therefore Tax collecting Agency has to be efficient and deligent in the task entrusted to it. In India, tax Administration witnessing from an errosen of this efficiency which has lead to wide spread evils of tax evasion and mountaining volume of tax arrears. Referring to inefficiency of the Tax administration in India. Prof. Kaldor said " In this respect I feel that there is too much of false and misguided economy in India"[1]. Apart from this, complicity and frequent changes in direct Tax Law have reduced the efficiency of the Tax Administration and this may lead to low collection of taxes.It is in this context E.A.R.C.* also observed that unnecessary complicity in procedure tend

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1. Nicholas Kaldor, Reports on Taxation - II Gerald & Duck Worth & Co.Ltd., London, 1980, P. 168.

* Economic Administrative Reform Commission.

to slow down the assessment and collection of taxes. The Commission further stated that many of procedures are now in vague and are far too complicated and sometimes their harrassment potential seems to out-weight their revenue potential. Thus in India Administrative inefficiency and low integrity of the staff, coupled with the lack of tax mortality on the part of tax payers are factors mainly responsible for low collection of direct taxes and this also leads to wild spared evils of tax, evasion and mountaining volume of tax arrears. This involves enormous loss to Government of India. It is,therefore, efficient tax administration in country like ours is the need of hour and the problem of attainment of efficient Administratiion needs immediate and serious consideration from the point of view of augmenting direct tax revenue.

3:5 TAX EVASION AND AVOIDANCE :

The problem of tax evasion and avoidance is one of the most serious ones of our tax system. "Tax evasion is an illegal way of avoiding tax liabilities, on the other hand tax avoidance is avoiding tax liability by taking advantages of loop-holes in tax laws"[1]. In both the cases

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1. H. L. Bhatia : Op.Cit., P.425.

ex-chequer lose revenue. The tendency to avoid direct taxes is more intense especially because of direct tax payer directly bebefited by avoiding direct tax. "Every efforts of tax payer within view to plug of loopholes in process of making the tax law quite curbersome, but these in the practice of avoiding"[1]. The practice of tax evasion and avoidance is evident only in higher income group of people and it's impact on those who pay tax honestly. Thus black money and inflation preserve in economy due to avoidance and evasion. The experience of last six plans shows in India that fruits of development have been taken away by previleged few and there has been considerable size of black money and unreported income.

A number of studies have been made estimating the size of unreported income. Studies made by senior officials of IMF records that, India heads list of 19 countries surved by them with the magnitude of underground economy touching atmost 50% of GNP as against over 20% of GNP in U.S.A., 20% in Kanada, and less than 10% in U.K. Estimated black money by national institute of public finance and policy will be 30% of GNP. The bulk proportion of black money in India is a serious matter for tax

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1. Ibid, P. 425.

administration. The reasons for tax evasion are so many and inter dependnet. In some circles it is believed that in India high rate of direct taxation are basically responsible for large scale tax evasion. Some of the other reasons (a) Inefficient tax administration responsible for increasing quantum of tax evasion, (b) Penal action and provision in India should not shown effectively. In India penalty is vary small quantum should not effect on tax evador, (c) Appropriate account are not maintained by businessman and individual, (d) Complicated tax law. Due to it's complication " more accurately taking advantages of the loop-holes in tax law would amount to tax avoidance rather than tax evasion"[1]. Any way as it is our tax law, are highly complicated with a number of exemptions, rebetes, concessions and surcharges. Hence state of confusion arises. This may lead to tax avoidance practice in our country. Various proposals and steps have been put by Government to checking evils of evasion. One such proposal is formed in Indian tax reform by Kaldor-in 1956. According to him, direct tax system in India had many defects. The present system of direct taxation in India is both inefficient and inequitable[2] and he proposing his

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1. H. L. Bhatia : Op.Cit. P - 428
2. Nicholas Kaldor, Op.cit. P.35

scheme of tax reform, Kaldor emphasised the need to have appropriate definition of income in India. This would ensure simplicity certainty and thereby reducing the scope of tax evasion. However, Kaldor's proposal would not ensure the complete pluging tax evasion. Hence government lunched voluntary disclosure scheme in 1975 and in again in 1981 to bring black money parellel economy. But results of these schemes also show engative and government failed in its efforts towards the black money.

Thus direct tax especially income and corporate tax structure in India is highly complicated and open loop-holes for tax avoidance and evasion. This involves an enormous loss to the Government and ultimately seriously affect on volume of development finance.