CHAPTER TWO

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2.1 CHARACTERISTICS OF A TAX:

A good tax is the one which will satisfy both taxpayers and the nation, as a whole, and also is convenient to both. Following are the characteristics of a tax.

(1) <u>Tax is a payment to the Government by the Public</u>:

If payments are made by people among themselves or from government to the people, they are not taxes. This implies that taxes are imposed only by authoritative institutions and under such institutions we can take here none except the government. So, taxes are the payments by public to the Government only.

(2) <u>Payment of taxes is compulosry</u>:

Payment of taxes is compulsory if the taxpayer has attained the conditions which are given in the law as sufficient for the imposition of a tax. If these conditions are there, refraining from the payment of tax is legally a crime. But if one does not pay a tax because one has not acquired sufficient conditions for the imposition of a tax, one commits no crime. Thus, taxes are 'compulosry' in a specific sense.

(3) <u>Element of sacrifice</u>:

Element of sacrifice is there in the payment of a tax, in addition to the legal compulsion. We are also legally bound to pay the prices of provisions which we buy, but it is merely a commercial transaction and we pay price because we have to do so. But in case of taxes, atleast in theory, a sense of sacrifice is there, as the taxpayer pays the taxes for public interest. This is somewhat far-fetched idea but is found being practised under the system of enlightened democracy and citizenship.

(4) Aim of tax collection is public good:

It is for the benefit of the general public and for the maximum welfare of the entire community that taxes are leived and collected. The use of taxes in the welfare of vested individual interests or for the development of a particular section in a way not agreeable to the general public is not permissible. Tax revenue is spent taking view of the aggregate welfare of the society and not of a particular section of it.

(5) Benefit received is not directly the return of tax:

Although a person may receive benefits accuring from the expenditure of the funds of which his contribution in the form of taxes constitutes a part, yet it is not intended or guaranteed by the state to give these benefits to a particular person in return of and in proportion to the payment he has made in the form of taxes.

(6) Tax is not the cost of the benefit:

Tax is not the cost of the benefit conferred by the government on the public. Benefits and taxes are independent of each other. A tax is never collected or deemed as the cost of the benefit to be so conferred. A tax has no relation with the cost of service that a government renders to an individual.

(7) Taxes are paid out of income:

Taxes are paid out of income, though they may be saving a part out of income. In the words of Dalton "Distinction between taxes-assessed on income and on capital, respectively, is often confused with the quite separate distinction between taxes paid out of income and capital, respectively. But a tax assessed on capital may be paid out of income and conversely. A man liable to pay death duties may pay them out of income, a man may sell securities or borrow from his bank in order to pay income-tax". Hence the distinction has no importance.

(8) Taxes are paid by the persons:

Taxes are paid by the person though they may be levied on persons or things. To pay tax is the personal responsibility of an individual as the possession, which he has and on which taxes are levied, cannot pay tax. All taxes are paid by individuals and not by the goods on which they are levied.

(9) Tax is a legal provision:

It is only after the levy of a tax that it becomes an act of the government. As had already been pointed out in the first point above, it is the authority of the State that can impose taxes. Taxes become legal provisions, their collection is legal and a person failing to pay them is liable to legal punishment [1].

2.2 CANONS OF TAXATION:

By Canons of Taxation, we mean those characteristics which a good tax should possess. These are the qualities of a good tax and not the principles on the basis of which taxes are levied. Very often, the Canons of Taxation are confused with the priniples of taxation. But these must be clearly distinguished so as to facilitate a clear understanding of the theory of taxation.

Adam Smith enemurated the following four Canons of Taxation which have become classic and are accepted universally by all the economists and men on the practical side of finance:

(1) Canon of Equality:

Equality in a broad sense, may be said to be the same as equity and justice. Equality does not mean that every person or group of persons should pay taxes in equal amounts irrespective of the wealth or income they possess. But it means just the contrary. While discussing the Canon of Equality, Adam Smith wrote "The subject 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 they respectively enjoy under the protection of the state ...". In other words, every person will pay taxes to the government in proportion to his "Ability-to-Pay". The direct taxes in India, like the income tax and the wealth tax, are based on the canon of equity or the ability-to-pay. Likewise, some commodity taxes like the excise-duties on consumer durables or luxury goods such as motorcars, television sets, airconditioners, etc., are also based on the Canon of Equity.

(2) Canon of Certainty:

The tax which an individual has to pay should be certain, not arbitrary. The taxpayer should know in advance how much tax he has to pay, at what time he has to pay it and in what form it is to be paid. A tax which is certain does not pinch the taxpayer.

(3) Canon of Convenience:

Every tax should be levied in such a manner and at such a time that it affords the maximum of convenience to the taxpayer. The reason is that the taxpayer makes a sacrifice at the time of payment of the tax. Hence the government should see to it that the taxpayer suffers no inconvenience on account of the payment of the tax.

(4) Canon of Economy:

The cost of collection should be minimum. If a major portion of tax proceeds is spent on the collection itself, then such a tax cannot be considered as a good tax. The expenditure tax, for example, does not satisfy the canon of economy. Canon of economy implies the reduction of all these ways to the least posssible.

The above four Canons of Taxation are the most significant and have an inevitable place in every financial structure. In addition to the above four, following other canons have been advanced by certain other ecomomists.

(a) Canon of Productivity, (b) Canon of Elesticity,
(c) Canon of Diversity, (d) Canon of Simplicity,
(e) Canon of Expediency, (f) Canon of Co-ordination [2].

2.2.1 Charateristics of a good Tax System:

Following are the characteristics of a good tax system.

(1) Equity: The burden of tax should be distributed amongst different sections of the community in a just and equitable manner. The heaviest burden should be borne by the broadest shoulders. As is well known, direct taxes impose a heavier burden on richer sections. As against this, burden of the indirect taxes falls more heavily on the poorer sections of the community. Hence it is essential to have a proper blending of direct and indirect taxes to make the system equitable and just.

(2) Productivity: The term 'Productivity' is interpreted in two senses, (a) the taxation system should be such as to provide adequate income to the government to meet its expenditure, (b) the taxation system should be such as to produce no adverse effects on the productive capacity of the country.

(3) Elasticity: The taxation system should provide to the government increased income with increase in the national income. The taxation system should also yield more income when the government expenditure goes up at the time of emergency or crisis or war.

(4) Convenience: Since the taxpayers make sacrifices when they pay the taxes it is essential for the government to see that they are not put to any avoidable inconvenience. There should be no harassment of the taxpayers under any circumstances.

(5) Absence of Tax-evasion: The tax system of the country should be so devised as to leave no scope for tax evasion on the part of the taxpayers. To achieve this objective, there should be a proper blending of all sorts of commodity and personal taxes. This will reduce the scope for tax evasion to the minimum.

(6) Conducive to Economic Growth and Resource Mobilization: It should generate a healthy investment climate and provide incentives to the entrepreneurial classes to come forward and set-up new business and industrial enterprises in the country. The resource mobilization is concerned with steeply graded direct taxes on income and wealth and high commodity taxes on income and wealth and high commodity taxes on luxury items will help to raise adequate financial resources for being ploughed back for further development of the economy.

(7) Counter-Revolutionary: Inflation is the worst enemy of the developing countries. It not only erodes the real income of the masses but also perpetuates glaring inequalities of income and wealth.

(8) Maximum Social Advantage: That system of taxation is the best which is based on the principle of maximum social advantages.

(9) Widening of Tax Burden: The burden of the tax should be wide and if the taxpayers are more, the burden of tax on each will come to be the minimum.

(10) Simplicity and Economy: The tax system should be as simple as possible so that it is easily intelligible to the laymen without the help of legal experts and the cost of collection should be less otherwise, it should be discarded in the national interest [3].

Income-tax should be progressive, that is, after exempting the poorest classes, the rate of tax should increase with every increase in income. Though there is agreement on progression, there is much less agreement with respect to the appropriate degree and nature of progression. The real problem is as regards the rate structure of the tax. The proper rate structure which will embody the principle of progression will be determined on the basis of two considerations:

(a) the general attitude of people towards equity in the distribution of income in a particular society; and

(b) the significance of any economic effects which may be produced by progression.

As regards the first question, there indeed are variations in the attitude among people, but the general view seems to support the principle that a fairly rapid progression which rises to a very high rate is desirable in the interest of justice. There are, of course, some who believe that progression should be very much less, on the ground that a steeply progressive income-tax will also adversely affect the willingness and the capacity to work and consequently further affect the productivity. Economists note that the degree of progression, even though very severe, does not prevent a high degree of investment and general prosperity.

Direct taxes are based on the principle of ability-to-pay so that the burden of taxation is distributed on different people and institutions in a just or equitable manner. They are amenable to fine gradations or progression.

Direct taxes satisfy the Canon of Certainty. A taxpayer is certain as to how much he is expected to pay and the State can estimate the yield from direct taxes fairly accurately and adjust its income and expenditure.

Direct taxes are elastic, in the sense that with the increase in income and wealth of the people, the yield of direct taxes will also increase. Elasticity implies that the Government's revenue can be increased simply by raising the rates of taxation. To modern Governments, with continuously expanding needs, such elastic taxes are very useful indeed.

Direct taxes create civic consciousness. In the case of direct taxes, taxpayers are made to feel directly the burden of taxes and hence, they take intelligent and keen interest in the way public income is spent. Taxpayers are likely to be more mindful about their rights and responsibilities as citizens of the State. Direct taxes are economical in the sense that the cost of collecting them is rather low. A direct tax like the income-tax is collected at source in the case of salaried persons [4].

Currently, the income tax is regulated under the Income-tax Act, 1961, which has undergone more than 3000 amendments. These amendments have covered exemptions, rebates, concessions, deductions, calculation of taxable income, rate schedules, surcharges and so on. There was a time when the income-tax rate, inclusive of surcharge, was as high as 97.5% for the highest income slab. It was subsequently lowered on the recommendation of the Wanchoo Committee and is now 40% plus surcharge for the highest income slab.

Frequent and bewildering changes have been taking place in certain other aspects of income tax. For example, the way in which a Hindu undivided family is treated vis-a-vis an individual taxpayer has been modified quite frequently. Similarly, there have been yearly changes in the rates and provisions of exemptions designed to encourage savings or a particular type of investment, etc. Areas of wealth tax, capital gains tax have also been subjected to quick changes.

In the Long Term Fiscal Policy announced in December, 1985, the Government promised to introduce greater stability in direct tax system and generally not to revise the tax provisions for a few years at a time. But the practice of introducing bewildering changes continued even in the name of rationalization and simplification. A comprehensive restructuring of direct tax system was adopted in early 1989 with the objective of further simplifying these taxes. The changes claimed to make it easier and simpler for the honest taxpayer to pay the taxes, while punishing the tax-evader heavily. However, critics maintain that the changes made the tax structure only more complicated. In line with the recommendations of the Chelliah Committee, most rebates and exemptions have now been withdrawn in exchange for a reduction in the tax rates [5].

2.3 ROLE OF DIRECT TAXES IN REVENUE MOBILIZATION:

Taxation constitutes the most important source of revenue for the Government and possesses the following essential characteristics:

(1) It is a compulsory payment and every citizen of the country is legally bound to pay the tax imposed upon him. If a person does not pay the tax, he can be punished by the government;

(2) Tax is paid by the taxpayer to enable the government to incur certain expenses in the common interests of the society;

(3) Payment of tax by a person does not entitle him to receive any direct benefit or services from the Government in return for the tax paid;

(4) There is no direct relationship between the tax paid by the person and the benefits that he may receive as a result of government expenditure [6].

2.4 DIRECT TAXES CONTRIBUTION:

A direct tax is that tax whose burden is borne by the person on whom it is levied. He cannot transfer it on to some other person. In other words, direct tax is that tax under which the impact and the incidence are on the same person. As against this, an indirect tax is that tax in which the impact and the incidence are on different persons, e.g. the impact of the import tax is on the importer but its incidence is on the consumers. As the impact and the incidence are on the same person in the case of income-tax, it is a direct tax. Likewise, Wealth-tax, Capital gains-tax, Gift-tax, Property-tax, and Death-duties are direct taxes; while sales-tax, customs-duties and excise-duties are indirect taxes.

As stated earlier, the present study is concerned with only three direct taxes, namely, the income-tax the wealth tax and the gift tax.

2.5 SOURCES OF REVENUE:

Taxes are the sources of revenue for the central and the state governments. But given the highly skewed distribution of incomes and property the tax-base for direct taxes is extremely narrow. Attempts to increase revenue by raising the rates of direct taxes have proved to be counter-productive as it induced large-scale tax evasion. Efforts are already being made to correct this situation by reducing the rate of taxes at the top of the scale. Simultaneously, the tax administration is being strengthened and geared to deal more stringently with tax-evasion. The number of income tax payers has increased steadily between 1981-82 and 1987-88 from nearly 4.7 million to around 8 million [7].

Public Revenue:

The subject of 'Public-Revenue' deals with the revenue-raising activities of the public bodies and its various underlying principles: To begin with, the Union Government has:

(a) a revenue budget, that is to say the estimates of receipts and disbursements on revenue account, and

(b) a capital budget, which relates to receipts and disbursements on capital account.

Estimates on revenue account have been grouped under two broad headings: (1) Tax-revenues; and (2) Non-tax revenues.

(1) Tax revenue has been divided into:

a. Taxes on income and expenditure. There are two types of income-tax, viz. the personal income-tax and the corporation tax;

b. Taxes on property and capital transactions; these include Wealth-tax, Gift-tax and Estate duty;

c. Taxes on commodities and services. These includes central excise duties, customs duties and sales-tax, state excise duties, taxes on vehicles, etc.

(2) Non-tax revenue has been divided into:

a. Fiscal and other services: Fiscal services relate to the revenue received by the Central Government from: (i) Currency, coinage and mint; and (ii) other fical services relating to India Security Presses at Nasik, Hyderabad, etc. General services include also the social and the community services, economic services and grants-in-aid and contributions;

b. Interest receipts: These constitute the most important source of non-tax revenue and comprise interest on loans to States and Union Territoties, interest payable by Railway and Postal Services, etc.

c. Dividends and Profits: These relate to the profit of the Reserve Bank of India, profits of Nationalized Banks, Life Insurance Coporation, Public Enterprises, etc. [8].

Direct Tax Treds in Developed and
Underdeveloped Countries:

The tax systems of almost all underdeveloped contries are characterised by the small proportion of revenue raised by direct taxation. On the other hand, direct taxes, as percentage of total tax revenue occupy relatively greater importance in the tax structure of developed contries. This is clearly shown in Table 2.1.

Table 2.1
Direct Tax Revenue as Percentage of Total Tax Revenue in Developed and Underdeveloped Countries for the year 1962-63

Developed Countries		Under Developed Countries	
United Kingdom	47.9	Ceylon	25.0
Australia	58.5	Burma	24.7
West Germany	57.4	Argentina	26.1
France	30.0	Pakistan	28.2
U.S.A	60.8	Philippines	28.3
Canada	63.0	India	29.6
Japan	53.8	Mexico	36.3
Average	53.1	Average	28.4

The comparison may not be all perfect but from the broad pattern which emerges from the above Table, it is clear that direct taxes make a much smaller contribution to total tax revenue in underdeveloped countries. The Table shows that the average percentage of direct tax revenue to total tax revenue in developed countries is 53.1 whereas in the under developed contries, it is only 28.4 [9].

Income-Tax:

Taxation of income has become the most important type of direct taxation everywhere. Income is generally regarded as the best measure of the ability in the sense of economic wellbeing. Tax could be so adjusted as to exempt the lowest income groups from the operation of the tax and make the richer groups bear the burden of the tax according to their respective incomes.

In a developing country like India, revenue generation through direct taxes occupies a prominent place. Greater attention is now being paid to the wider coverage of the taxpayers in the direct tax areas, Especially, the income tax is occupying a prominent place in direct taxes. Following Table shows the growth in the number of income taxpayers over the years.

Table 2.2
Growth in Number of
Income-tax Payers

Years	No. in Millions
1975-76	3.8
1980-81	4.6
1981-82	4.7
1982-83	4.8
1983-84	4.9
1984-85	4.9
1985-86	5.5
1986-87	6.3
1987-88	7.8

Source: Annual Report-1988-89,
Ministry of Finance,
Government of India.

Table 2.2 indicates that the number of the income-tax payers is very low compared to the total population. Even at the current levels, it is hardly 0.07% of the total population. For the purpose of improving this Chelliah Committe recommended in its Report that for broadening the tax-base and improving the fairness of income-tax system, i.e. instead of increasing the tax rate, it is better to find new areas of taxation and it may be possible to distribute the burden of taxation on some more people. Fiscal policy has to aim at creating a climate which will allow an ample use of direct taxes in the long run.

In underdeveloped countries, as development progresses, direct taxes should gradually come into prominence. In the early stages of economic development, the tax system of U.K. and the U.S.A. were dominated by outlay taxes and were regressive in nature. In modern times, however, the taxes on income and wealth are more important in their tax structure than the indirect taxes.

In underdeveloped countries, 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 exemption 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. "The traditional objective fo progressivity and eguity in taxation reinforced by the modern economic objectives of taxation, have pointed strongly to more aggressive use of net-income and wealth taxation [10].

2.6 ROLE OF DIRECT TAXATION IN ECONOMIC GROWTH:

In the process of economic development of underdeveloped countries, the state has come to assume a leading role. The State can influence the level of economic activity by proper manipulation of fiscal policy connected with governmental revenues and expenditures. Being an instrument of fiscal policy, taxation can have significant effects on the rate of economic growth.

The Concept of Economic Growth:

Generally when talking of economic growth, we conceive of an increase in real production. So economic growth should mean "an increase in national product at constant prices". This is the simple interpretation of economic growth as the difference in real production of any two successive periods. But some other concepts of growth may also be noted. Since per-capita output does not necessarily increase with higher production caused by an increase in the labourforce, some economists define economic growth as the increase in production relative to the volume of labour or size of population. Others maintain that the most important factors determining the rate of economic growth are the proportion of a community's income devoted to saving and capital formation.

Economic growth comes very close to making the productivity of labour a standard of measurement, i.e. growth originates in higher labour productivity. A similar view can be expressed with respect to the increased productivity of capital. These two concepts - productivity of labour and productivity of capital - are measures of economic growth.

The effect of taxation on economic growth, therefore can be analysed in terms of its influence on labour supply, on capital formation and on technological change or on increase in knowledge. There are at least five ways in which the tax policy may effect the process of economic growth:

(1) The level of aggregate demand will be determined by the automatic response of revenues to economic growth, accompained by expenditure trends;

(2) The level of surplus or dificit of the budget will add or subtract from the supply of saving;

(3) The general character of the tax system will influence the total rate of saving and investment;

(4) Specific structural characteristics will influence both total savings and investment and the sectoral distribution of investment;

(5) Changes in tax rates or the nature of the taxes themselves can influence growth either by design or by accident.

The Objective of Tax Policy:

Now before we discuss in detail the role of direct taxation in economic growth, we should underline the objectives of tax policy in the context of development. This is because " A tax Policy is only a means to an end and, therefore, the first step in formulating it is to determine the socio-economic goals being sought and then to train the policy measures to achive that objective otherwise the means may be confused with the ends". In a developing economy, tax policy may be used for achieving the following objectives:

(1) The tax policy should accelerate the tempo of economic growth to the maximum extent possible. For this purpose, it should:-

   (a) Restrict consumption expenditure without impairing the total output for increasing the rate of capital formation

   (b) Encourage investment in new capital goods

   (c) Channel investment into those sectors which contribute the most to the economic growth; and

   (d) Increase total factor-supply or factor unit-efficiency (for example, by encouraging persons to enter the labour market, to work more, to adopt more efficient techniques, etc.

(2) The tax Policy should impart built in flexibility into the tax structure and provide continuing maximum revenue productivity

consistent with the optimum growth rate. The built-in flexibility generates additional revenue to the state as incomes rise without frequently going in for legislative sanction and at the same time provides for an anti-inflationary mechanism. The built-in flexibility of a particular tax depends on the width of the tax base relative to national income, the responsivenes of the tax base to changes in national income and the rate structure of the tax. Thus, the wider the base of a particular tax, the more responsive the tax base to changes in national income; and the more progressive its rate structure the greater will be its built-in flexibility". The tax policy should aim at maximum possible built-in flexibility in the tax structure, specially in underdeveloped countries where the need for extra resources is very urgent in the context of economic growth.

(3) Taxes should act as instruments for containing inflationary pressures which characterise the initial stages of heavy investments in most underdeveloped countries. As pointed out earlier, the system of built-in flexibility is very much consistent with an anti-inflationary tax policy. However, a vigorous application of tax policy refleted in highty progressive tax rates designed to keep down inflationary trends may have disincentive effects on production and investment and the supply of factors. Therefore, the aim of this tax function should be to steer a smooth course between the storms of inflation on the one side and uneasy calms of disincentive effect on the other. This would ensure a smooth course of economic growth.

(4) The aim of tax policy in a developing economy should also be to remove the inequality of income in the society. This principle of

equity assumes more importance in developed countries where the urge for equality of incomes is very great. However even if the latter view is correct, we cannot rule out some disincentive effect on investment of highly progressive tax rate designed to reduce inequality of incomes. The tax policy should try to minimise this disincentive effect as far as possible while pursuing the equity objective. Again, while framing a tax policy, distinction should be made between the inequality of incomes and functional inequality. It is maintained that if we are to get sufficient supplies of the skills and enterprises needed for rapid development, we must have functional inequality. In increasing functional and decreasing non-functional inequalities, the tax structure can play an important part.

(5) The tax structure should be simple, feasible of effective administration, less costly and easy of compliance on the part of the taxpayer and enforcement on the part of the government.

We must note in this connection that there may be serious conflicts among these objectives. For example, income-tax which is said to be most equitable and most responsive in revenue to expansion of the economy is most likely, if raised, to high to have adverse effects. Similarly consumption taxes are most likely to encourage savings, but they are less likely to conform with the principle of equity. What is needed is that the overall tax structure must reflect a compromise among conflicting considerations.

Tax policy also aims at offsetting the fluctuation in the volume of capital formation which disturbs economic stability. Lastly, tax policy also takes care of the composition of investment and provides for preferential tax treatment to certain desirable investments [11].

2.7 CHARACTERISTICS OF A GOOD TAX STRUCTURE:

While interpreting the phrase "the structure of direct taxes" one ought to seek answers to questions of the following kind: Do the various direct taxes make a coherent whole or do they overlap and impinge on each other in an inconsistent and undesirable manner? Are there any way in which, for example, the tax bases of a particular direct tax and the rules relating to one such tax to another could be modified so as to make the whole structure simpler, more effective and fairer in its operation?. In order to answer such questions, one must have in mind what one would regard as the desirable characteristic, of a tax structure. The most important of these must be considered under the following six headings: (1) Incentives and economic efficiency, (2) Distributional effects, (3) International aspects, (4) Simplicity and cost of administration and compliance, (5) Flexibility and Stability, (6) Transitional problems.

(1) <u>Incentives and Economic Efficiency</u>:

There are many channels through which a tax system may effect economic efficiency. It can have important effects on incentives and opportunities to work, to save, to invest in capital development, to take risks and to innovate, to use resources efficiently and to allocate them to use that best serves the need of the society.

To a large extent, these efficiency effects depend upon the total level of taxation. If the need for tax revenue to finance a large public sector is high, some tax rates will inevitably be high, with inevitable effects upon some economic opportunities and incentives. There are different way of raising a given tax revenue with differing effects upon economic opportunities and incentives.

An economist distinguishes between the 'income effect' and the 'substitution effect' of a tax burden. Thus, heavier taxes on income will reduce the taxpayer's spendable income and this considaration alone would probably make it desirable for him to work harder to restore in part his post-tax income (the 'income effect') but at the same time, a higher marginal tax rate will reduce the net spendable income which he can get from extra hours of work, and this reduction in the extra goods which he can earn from an hour's work will tend to make him prefer leisure to work (the 'substitution effect').

(2) Distributional Effects:

Any system of taxes is bound to have distributional effects even if it is only a matter of deciding who should bear the burden of the tax revenue needed to finance some particular level of budgetary expenditure. For example, social security has been regarded atleast partly in this light with the implication that the insured should pay contributions which are related to the benefits which they may expect to derive from the scheme. But in many cases, such as National Defence, it is difficult or impossible to attribute different amounts of benefits, which they may expect to derive from the scheme.

Moreover, in a modern society, the distributional aspects of a fiscal system are often more pervasive and more purposive than the simple determination of who should bear the burden of an otherwise given level of government expenditure; progressive taxation combined with

Social Security benefits and other elements of social expenditure (e.g. on education or health) are often expressly designed to improve the relative position of the poorer members of society.

In addition to the effect of a tax system on redistribution between rich and poor (the effects on 'vertical' redistribution), the equity of a tax system must also be judged by the extent to which it treats fairly and equally those members of society who are equally rich or poor (the 'horizontal' equity criterion). The following points are clear:

1. A good tax system should be horizontally equitable, i.e. should treat like-with-like;
2. A modern tax system must be so constructed as to be capable of use for vertical redistribution between rich and poor.
3. There would almost inevitably be some clash between the criteria of economic efficiency (which require low marginal tax rates) and of vertical redistribution (which will require high average rates of tax on the rich); but a good tax system is the one which minimises this clash and promotes a given redistribution with a minimum loss of efficiency.
4. The final choice of redistributional aims for a tax system involves basic value judgements about the nature of a good society, which are matters for political decision. But a good tax structure is the one which is sufficiently flexible to allow scope in a democratic society for different political choices (e.g. by variation in rates of tax).

(3) <u>International Aspects</u>:

Throughout the world, the main structure of taxation is a concern of national governments but the national economies which these governments influence by their tax-policies are in large measure open economies with very extensive and important economic and financial relations with each other. In particular, the experience of the 1930 taught Western industrialised countries the dangers of embarking upon autarkic restrictions on international transactions to the impoverishment of each other.

This system is now subject to a new challenge in the upprecedented experience of simultaneous international recession and inflation. The code of good behaviour in international economic and financial relationship is under review with the object of re-establishing and maintaining a system of reasonably free transactions between the countries concerned in order to avoid mutually destructive restrictions.

(4) <u>Simplicity and Costs of Administration and Compliance</u>:

In addition to being efficient and just and compatible with the country's international position, a good tax system should also be coherent, simple and straightforward. In a democratic society, one of the most important aspects of a tax system is that the taxing authorities should be accountable to the electorate at large. This can be so, only if the tax system is such that the man and woman in the street can comprehend clearly what is the nature of the taxpayers' liability. 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.

On the other hand, other things being equal, there are atleast three reasons for tipping the balance away from compliance costs on to official administrative costs, where it is reasonably possible to make a choice of administrative arrangement which have this effect.

1. Administrative costs are themselves from taxation which, can itself be determined with reference to fairness of tax burden, whereas compliance costs fall on the private taxpayers and can be markedly regressive in their incidence.
2. Compliance costs are likely to be much resented by taxpayers, particularly where much time and trouble must be spent by small taxpayers only to show a very low, or indeed a nil, liability to tax.
3. Administrative costs are easier of ascertainment and more open to public scrutiny than are compliance costs.

(5) <u>Flexibility and Stability</u>:

A good tax structure must be flexible for two rather distinct purposes; the first being primarily economic and the second primarily political.

In the former category, there must be recognition of the need to be able to adjust total tax burdens reasonably, rapidly and frequently, in the interests of demand management. One of the tools of control in the hands of Governments is to plan total taxation in part as a means for the stimulation or restriction of the total demand for goods and services by the private sector of the economy. Fashions change in the relative emphasis placed on monetary policy and on fiscal policy for this purpose; but unless and until there is general political agreement that fiscal policy should not be used for this purpose, one criterion for an acceptable tax structure is that it should contain important elements which can be varied flexibly for this purpose.

But in a democratic community, flexibility in a tax system is needed for a more basically political reason. Different political parties represent in part different political, social and economic philosophies. In a healthy democratic society, there must be broad political consensus, atleast willingness, to compromise over certain basic matters; but there must, at the same time, be the possibility of change of emphasis in economic policy as one government succeeds another. Such changes of emphasis will show themselves in the trade-off, which is preferred among the various objectives of a good tax system.

At the same time, there is a clear need for a certain stability in taxation in order that persons may be in a position to make reasonably far-sighted plans. Fundamental uncertainly breeds lack of confidence and is a serious impediment to production and prosperity. In any such political consensus, there must be a combination of atleast two essential ingredients:

1. The tax system must leave room in a mixed economy for the operation of effective incentives for private enterprise.
2. The tax system must at the same time give scope for effective modification of the distribution of income and property, which would otherwise result from the unmodified operation of the free enterprise sector of the economy.

(6) <u>Transitional Problems</u>:

To devise relatively easy means of transition is in all cases an important objective. In addition, in recent years, there have been such rapid and frequent changes in the tax structure that there may well be a case for the postponement of some further changes, however desirable they may be in the longer run. In such a case, the wise course may be to have the new structure in mind as an agreed ultimate objective in order to be able to make sure that any smaller changes which may be made from time to time lead toward, rather than away from, the final goal.

In conclusion, it may be said that the choice of tax structure must take into account many factors; the effects on economic incentive; its fairness as between persons of similar taxable capacity; its effects upon distribution between rich and poor; whether it is compatible with desirable international economic relations, and its simplicity, ease of understanding and absence of excessive administrative costs. The transition from one tax structure to another inevitably takes time and involves costs which must be set against any gains expected from the new structure where these various characteristics conflict, it is an essential function of the political process to determine how much weight to give to each of them [12].

2.8 TAX DESIGN AND TAX REFORM:

The practice of tax design and tax reform has been with us for many centuries in one form or another. But these have not been properly conceptualized by experts in public finance. Past attempts to suggest normative economic criteria for 'optimal' taxation have ignored the close logical as well as practical relationship between tax-design and tax-reform. In these recent attempts, while the economists have gone on theorizing on optimal tax design, tax lawyers have concentrated their efforts mostly on tax reform. But any useful exercise on tax reform should take into account both the theory and practice of tax design.

Since both tax design and tax reform are concerned with practical aspect of the operation of the tax structure.

Thus, the study of tax design and tax reform, in order to be more useful in practical application, should encompass economic, legal and administrative aspects. Such a comprehensive approach to tax design and tax reform needs to be emphasized in view of the disconnected way in which they have been studied and also because of the isolated attempts of economists and tax lawyers to formulate general guidelines for tax design and tax reform.

Tax design is concerned with designing a tax or tax structure de novo, whereas tax reform is concerned with adapting an existing tax or a tax structure to changed circumstances.

Tax design includes: (a) imposition of an altogether new tax, (b) replacing an already existing tax by a new tax, (c) abolishing an already existing tax to give a new appearance to the tax structure, and (d) introducing new tax base and/or new rate structure to the existing tax. Tax reform includes introducing changes in the existing tax-base, taxs-rates, exemptions, concessions and the administrative procedures.

For the purpose of clear understanding, tax design and tax reform may be classified into three categories based on the agency in charge of designing the tax and suggesting tax reforms. They are: (a) tax designing and tax reform by the Legislature, (b) tax designing and tax reform by the executive, and (c) tax designing and tax reform recommended by an expert committee.

When a new tax is suggested and its actual design is shaped in the legislative process based on public opinion and/or under the pressure of 'self-interest groups', it becomes a tax design by the Legislature. This includes the stages of initiating public discussion, pressuring the government to introduce the necessary legislation based on such opinions, changes proposed in the committees of the legislature and the changes proposed in the Legislature while enacting the legislation.

Tax design and tax reform by the executive refers to the initiative taken by the bureaucracy to persuade the government to accept its suggested tax design and reform based on its own thinking, exeperience or by independent expert opinion.

Finally, tax design and tax reform suggested by an independent expert committee appointed by the government is the most important and desirable type of tax designing and tax reform. This is because the necessary information and technical know-how, which go with an expert committee, may be absent in the first two types of tax designing and tax reform. Further, the required objectivity, both in identifying the desirable characteristics of the design and tax reform evaluating dispassionately the existing tax structure and formulating more objective measures can be expected from an independent expert committee. It is plausible that even this category of tax designing and tax reforms may be initiated by the legislations, demand and/or bureaucracy's realization of the need for seeking the advice of an independent expert committee. Therefore, in the ultimate analysis, all these three types of process of tax design and tax reforms are interrelated.

Tax design is the science and art of creating the structure of a tax and/or the tax structure, as a whole. This involves choice of taxes, choice of tax bases, choice of tax rates, choice of other elements of tax structure such as exemptions, deductions, etc.

Once the tax/tax structure is designed on the basis of such criteria, it goes into operation as soon as it is implemented. From its practical operation, besides the taxpaying public, the government and the tax administrators learn about the merits and demerits of the tax structure, either on the basis of practical experiences or from empirical tests or both. The merits and demerits of a tax/tax structure are examined and identified with reference to the major objectives which the tax/tax structure is supposed to activate. These objectives are invariably the economic policy objectives or plan objectives of the government, which are attempted to be achieved through the budget. While considering the rationality of tax design/tax reform, we examine them with reference to certain economic policy objectives of the government. These objective functions are with reference to tax collecting social-agent, which is the government. Generally, accepted objectives include promoting higher growth rate of national output, reducing wide inequalities of income and wealth, maintaining stability of the growth of output, prices and balance of payments, which are the supporting objectives for the first two objectives. Though these are the broad objectives of democratic society in normal times, other objectives like winning a war, rehabilitation of the people and the economy after war or after other calamities may emerge. However, such specification of objective functions is also necessary from the point of view of the taxpayer. In the ultimate analysis, we proceed from individual welfare functions to social welfare functions. Social welfare functions are decided by the government, keeping in view the preferences of the majority of the voters who are also the taxpayers. Hence, it may be assumed that the spectrum of individual objective welfare functions ultimately get reflected in the national policy objectives of the government.

If in the course of operation, a tax/tax-structure is not found to be serving these objectives, then introducing required corrections into the tax design become necessary. This is the core of tax reform. It starts with a thorough examination of the operation of tax/tax-structure in relation to the economy policy objectives; finding empirical facts about its defects, identifying the causes for defective operation, examining alternative measures to set right the defects and recommending specific tax reform measures in order to restore its effectiveness. It would be desirable to enumerate the relative merits and demerits of alternative tax reform measures and leave the choice to the policymakers.

Tax reform may also be necessitated by the (a) changed socio-economic and political situations, and (b) changed objectives. Changes in the economic structure may call for certain changes in the tax structure to achieve the same objectives. Change in the government may require change in the priority of different objectives and/or addition of new objectives. Hence, changes in tax structure become inevitable. Thus, tax design refers to creation of a tax structure and tax reform refers to changes in the tax structure to adapt it to the changed situations and objectives.

Optimal tax reform must take as its starting point, the existing tax system and the fact that actual changes are slow and piecemeal. It underlines the fact that tax design and tax reform are different and that any tax reform attempt should take for granted certain realities of the existing tax structure and any changes, if recommended, will be slow in getting injected into the existing tax structure. It also warns the tax reformers that it would be difficult to sell radical tax reform measures in democratic countries, not only because of the operation of the psychological law, viz. an old tax is a good tax, but also because of the complex reactions which radical tax reform measures might encounter from the self-interest pressure groups in democracies. Further, tax reform is a continuous process. Not only can no grand, once-for-all, reform scheme be realisti-cally expected to be adopted, but even if it were, it would never be sufficient for very long. Circumstances change and policies must change with them.

2.9 CHARACTERISTICS OF A WELL-DESIGNED TAX STRUCTURE:

It has been maintained by economists that the following characteristics should be obtained in a tax structure, as a whole, in order to make it more effective for the purpose of achieving economic policy objectives:

First, built-in elasticity of revenue yield, to meet the ever-growing revenue needs of the government;

Second, progressivity in rate structure so as to make the distribution of the tax share of individuals more equitable, as also to reduce inequalities of income created by the market forces;

Third, planned non-neutrality in the sense that absence of haphazard and random distortion of resource allocation, including consumption, investment, saving, leisure, etc.; and

Fourth, simplicity in administering the taxes, so as to minimize both the cost of collection and the cost of tax compliance.

These characteristics should be injected into each and every tax, if possible. But in view of the difficulty of creating such an ideal situation, atleast the tax structure, as a whole, should have these characteristics.

(1) Built-in Elasticity of Tax Revenue:

In view of the growing importance of the public sector in both Developed and Developing Countries, the revenue requirement of the government increases as the countries start moving from one stage to the other higher stage. As a result, it is argued that a tax structure should yield automatically increasing revenue as the national income increases, without requiring the tax rates, exemptions and coverage being altered every year. Though there is nothing wrong in altering these, it should be remembered that an element of stability and certainty should be injected into the tax structure; particularly in regard to the tax rates, exemption and coverage, in order to promote saving and investment. Further, frequent changes in tax rates, etc., invite political reactions which may result in tax revolts. Therefore, democratic countries should have a long-term perspective regarding tax rates, tax exemption and the coverage of the taxes. At the same time, they should be able to raise more and more revenue automatically as the national income increases. Hence, the tax structure should be elastic during the period when the rates, exemption and coverage of the base are kept constant. It has been proved that a progressive rate structure will have a high yield elasticity than other rate structures. Secondly, it has also been proved that the tax revenue which is related to the prices of the commodities, i.e. the value of commodities, is more elastic than that related to the quantity or volume of the commodities.

In any country, where large proportion of income is produced in the unorganized private sector, it is very difficult to have an elastic tax system through only direct tax on income. It becomes necessary to have taxes on commodities also. There again, in an attempt, to inject an element of progressivity, certain essential commodities will have to be exempted and in view of such narrowing down of the scope of commodity taxation, high rates on commodities of not-so-essential nature becomes inevitable.

Income-elasticity of the taxation also serves another purpose. It acts as a built-in stabilizer; particularly in the case of commodity taxation. As the prices of the commodities increase as a result of taxation, the consumer will have to pay more taxes and consequently, the real income will be reduced. This reduces real demand and acts as an automatic stabilizer of prices. The opposite happens when the prices fall. Thus, the elastic revenue system not only yields increasing revenue, but also acts as an automatic stabilizer to whatever marginal extent is possible.

2. Progressivity of Tax Structure:

The progressivity of rate structure has been advocated in most of the countries for reducing inequalities of income and wealth. But it is only in recent years that it has been recognized that the progressive rate structure also serves the purpose of revenue elasticity (and built-in flexibility), which helps achieving stabilization objective. Hence, the progressivity of tax structure has been considered as an important characteristic of the structure, as a whole. Since progressivity is intended mainly to aim at equity in tax burden distribution, attempts have been made to design taxes to achieve both 'horizontal equity' (equal tax burden on people whose economic positions are equal) and 'vertical equity' (unequal tax burden on people whose economic positions are unequal). However, such attempts have met with only partial success even with direct taxes because of administrative complexities they create. Though commodity taxes have been designed to achieve some kind of vertical equity, it is very difficult to design them for achieving horizontal equity. Therefore, the tax designer has to be content with achieving both vertical and horizontal equity through the tax structure, as a whole.

3. Planned Non-Neutrality of Tax Structure:

For a long time, the question of absolute neutrality of taxation was considered as an important virtue of a tax and tax structure. Gradually, however, this emphasis on absolute neutrality lost its importance. Today, what is relevant is the absence of haphazard distortion of allocation of resources. For it is accepted today that the market mechanism does not necessarily allocate resources in the economically and/or socially efficient way because of the monopoly situations, market imperfections and many other institutional factors. Therefore, government is supposed to influence the resource allocation in the desired way in the form of priorities. Economic policy and taxation should help the government in influencing the flow of resources in the planned way according to the priorities of the budget of the government, instead of distorting resource allocation haphazardly and creating the traditional excess burden. The planned interference of taxation in influencing the resource allocation is considered as a rational characteristic of taxation, particularly in developing countries, where market forces are distorted by various types of institutional factors. In such countries, taxation should change the relative prices of commodities in accordance with the priorities of the budget. Secondly, taxation should influence the choice between saving and investment and between leisures and income, according to the needs and conditions of the country. This means that both direct and indirect taxes should be used to reduce the demand for scarce commodities and to discourage the flow of scarce factors like capital into the production of luxury goods and socially undesirable commodities. This requires discriminatory commodity taxes which should fall heavily on luxuries and exempt the basic necessities of life. Further, income and corporate taxation should be used to encourage saving in the household and corporate sectors. This, in other words, means that socially appropriate allocation of resources cannot be achieved through budget only with one type of tax. Hence both direct and indirect taxes become essential.

Thus, in order to inject the characteristics of built-in elasticity, progressivity and planned non-neutrality into the tax structure, it should include a tax on income, a tax on the value of property and a tax on consumption or sale of final goods and services. Sometimes it becomes necessary to resort to even certain benefit taxation, such as fees and user-charges, even though they are not strictly called taxation. This is because they help in influencing allocation of resources.

4. <u>Simplicity of Tax Administration</u>:

Even the best designed tax structure may fail to achieve its objectives for want of proper administration. Therefore, simplicity of tax administration is a safeguard, not a panacea, against administrative failure to implement well conceived tax design and tax reforms. In this context, Richard M.Bird has observed that, "since the quality of tax administration is such an important constraint in the possibility of tax reform, it would appear logical to suggest tax reform, which can be administered by a poor administrator. Sound tax policy must be premised on a realistic understanding and appraisal of the capabilities of the tax administration ... A less than ideal tax designed for a poor administration may work better - its effects may be more in line with those desired - than a 'good' tax badly administered".

An important reason for emphasizing the simplicity in tax administration is that a tax/tax structure designed to possess the three characteristics, viz. built-in elasticity, progressivity and planned non-neutrality, become necessarily complicated. Therefore, to put a check on any further growth of complexity, it is necessary to keep the process of administration as simple as it is physically and legally possible.

This requires that (a) the complexity of tax law is kept to the minimum, and (b) administrative procedures are as easy to follow and to implement as possible. These simplifications, when achieved, will, to a large extent, fulfil Adam Smith's canons of convenience, certainty and economy. The tax administration should suit the convenience of taxpayers to pay, and in case of dispute, to appeal and to get justice without undue delay. The tax administration should also be able to keep the cost of tax collection and the cost of tax payment to the tolerable limits. The tax law should minimize arbitrary interpretation of the coverage of the tax base, application of the rates and allowance for exemptions and concessions. Thus, simplicity of tax administration is as important as the other three characteristics of tax design and tax reform in order to create a more desirable tax structure in democratic countries [13].

2.10 DIRECT TAX REFORMS:

In India, right since Independence, the subject of tax reform has been engaging the attention of the Government in an attempt to achieve the objectives of:

(1) Simplification and rationalization of tax laws;

(2) Control of tax evasion and blackmoney;

(3) Improvement in elasticity of tax revenue; and

(4) Better tax assessment and administration.

For this purpose, the Government had appointed many important Committees during the last three decades. Notable among these:

(1) Taxation Enquiry Commission (1953);

(2) Invitation to Professor Nicholas Kaldor by the Indian Statistical Institute to investigate into the Direct Tax Structure (1956);

(3) Bhootalingam Committee on Rationalization and Simplification of Tax Structure (1968);

(4) Direct Taxes Enquiry Committee (also known as Wanchoo Committee) to suggest measures to check evasion, changes in tax assessment and administration (1970);

(5) Dr.K.N.Raj Committee on Taxation of Agricultural Income and Wealth (1971); and

(6) Chokshi Committee on Direct Taxes (1977).

These Committees made a number of recommendations to sensitize the tax system of our country. particularly reduction and rationalization of structure of tax rates and tax limits, incentives and rebates on savings and investment, widening of tax base through levy of tax on capital gains, net wealth and gifts, substitution of expenditure for income as the tax base, rationalization of corporate taxes, abolition of surtax, adoption of a split rate system to avoid double taxation involved in taxation of corporate incomes as well as distributed dividends to shareholders, tax on agricultural holdings (AHT) and agricultural property.

Though a number of these recommendations were incorporated in direct tax laws from time to time, nothing substantial has been done to bring the structural reforms in the tax laws so as to make them more appropriate and responsive to the changing needs of the economy [14].

When public deficits need to be reduced, the economic cost of raising more revenue must be weighed against the cost of cutting public spending. More revenue and less spending will both be needed as a rule. The temptation in the short term is to rely on ad hoc increases in revenue because they are administratively and politically convenient. But in many countries, this approach has led to complex and highly distortionary revenue systems that not only fail to collect sufficient revenue but also damage long-term growth. Most of today's systems could be restructured to increase yield, reduce distortions and minimize the burden on the poor.

In general, the economic cost of taxation increases with the tax rate and is higher when the base is narrow, as is the case in most Developing Countries. To make the tax structure more transparent and to ease administration and enforcement, the reforms have also favoured fewer rates and fewer exemptions. They have tried to promote equity by improving the collection of taxes from the wealthy through limited exemptions and improved tax administration and by avoiding taxes on the poor. Progressive income taxes are hard to collect in Developing Countries [15].

Guiding Principles of Tax Reforms:

The following could be cited as the basic principles that should guide the process of tax reform:

(1) The tax system and its burden must be acceptable to the citizens, i.e. the potential taxpayers;

(2) Given the past experience and the present totality of circumstances affecting the tax system and its operation, it is better to have moderate rates with broader bases;

(3) While the tax structure should be progressive, it should not be such as to induce the generation of unaccounted income and wealth;

(4) The tax system must be rational from the economic point of view. For this purpose, the structure once established must remain stable unless and until the economic conditions undergo a radical transformation. _Ad hoc_ changes from year to year will undermine rationality and reintroduce complications.

(4) The tax system should be as simple as possible; it should have the strictly limited objectives of raising revenues for the government in a fair and efficient manner, achieving redistribution and discouraging some industries and the use of consumption of some products and protection to domestic industries. A simple system will have only a limited number or rates and exemptions or deductions and give the least possible discretionary power to the tax officials for interpreting the law.

(5) Methods of tax administration should be modernized and tax enforcement should be visibly improved.

(6) The tax reforms suggested should be fully or atleast nearly revenue neutral in their totality; however, the system should become more income elastic [16].

2.11 TAX BASE:

Expenditure-tax was originally called by different names. American authors used the term 'spendings-tax' and the British authors used the term 'consumption-tax'. But it was Nicholas Kaldor who called it an 'expenditure-tax'. There are certain valid reasons for calling the tax based on consumption as an 'expenditure-tax'. Traditionally, the tax on consumption has been in the form of commodity-taxes, which, in turn, assume the form of indirect taxes. They include excise-duties, turnover-tax, sales-tax and value added tax. Conceptually, such a tax, though a tax on consumption, is not neutral between different forms of consumption as the rates of tax differ from commodity to commodity, depending upon their nature and importance. Even the value added tax assumes the form of consumption based tax. Therefore, it was rightly designated as 'expenditure-tax', as the expenditure is derived in the aggregate sense by deducting aggregate savings from aggregate income. Consequently, the total expenditure is the tax-base in the case of expenditure-tax. The Mead Committee of UK has examined different forms of expenditure-tax, namely, (a) expenditure-tax adjustment of income base, (b) value-added method, and (c) hundred percent capital allowance method.

The tax base is estimated in the following way: all personal incomes such as wages, salaries, dividends, interest, rent, profits and royalties plus all capital receipts like realization of capital assets, amount borrowed, receipts of repayment of past loans, reduction in money balances, plus all windfall earnings like inheritance, gifts received. From this total income, non-consumption outgoings such as for acquisition of assets, the amount of money lent, repayment of past borrowings, increase in money balances, payment of interest on money borrowed, are deducted. What remains is the tax-base for the universal expenditure-tax. Though it is suggested to take the form of a surcharge on the incomes above a particular limit, the tax-base would be the same except that income-tax paid will be deducted from the tax-base.

The earlier experiments with expenditure-tax in India and Sri Lanka considered actual amount spent by individuals on goods and services as the tax base. This required a proof of purchase vouchers/bills for the purpose of determining the tax base, which was very difficult to obtain and hence, it became administratively unpopular. Precisely for this reason, namely, difficulty of tax enforcement, it could not yield adequate revenue and hence, became unproductive. The Swedish Proposal has worked out the tax base for expenditure-tax on the basis of the cash receipts such as regular income proceeds from the sale of investment assets, legacies, gifts, loans, lottery, prizes and the like, plus all dissavings such as reduction of bank deposits, reduction of claims, borrowings, minus all outgoing deductible amount to the accumulated balance of the acquisition of income outlays of investment in income yielding activities and also new savings in bank deposits, increase in the claims and repayment of loans. The net amount constitutes the individual tax base for expenditure tax. Thus, as against the existing income tax, which is based on the principle of ability-to-pay, the progressive expenditure tax is based on the principle of standard-of-living of the family or the individual as the tax-base.

Kaldor justifies expenditure as a better index of taxable capacity. This is supposed to indicate the better ability-to-pay than income. However, this argument does not withstand closer scrutiny in terms of economic logic as income is always a better index of economic ability by the mere fact that income is a larger magnitude than expenditure at higher levels of income [17].

2.12 EXEMPTIONS : MEANING, NATURE AND SIGNIFICANCE:

The Income-tax Act provides a number of exemptions, incentives, deductions and allowances linked with various purposes, which are important for the socio-economic development of the country. Some of the exemptions are given to encourage savings and investments in desired channels, in providing funds for nation-building activities. Some of the incentives, deductions, allowances, have the objective of stimulating industrial growth through setting up of new industries, expansion, optimum utilization of installed capacity, increasing production and export market. The objectives of certain other important concessions are to accelerate scientific research and technological development, facilitate in foreign collaboration and import of advanced, modern technology in certain fields of industry on a selective basis, augmenting foreign exchange resources through promotion of exports and widening the base of the economy by encouraging the growth of the cooperative and small-scale industries, particularly in rural or backward region.

Exemptions:

The incomes enumerated in this section are not only excluded from the taxable income of the assessee but also do not form part of his total income. In other words, they are not to be taken into computation for the purpose of determining either the taxable income or the rate of tax, except agricultural income, which is considered for rate purposes.

The entire scheme of Income-tax Act, 1961, has been devised under 23 Chapters, 298 Sections and 2 Schedules. Chapter-III of the Act provides exemptions to certain incomes under the title: 'INCOMES WHICH DO NOT FORM PART OF TOTAL INCOME' under the following headings:

(I) 1. Section 10:
Incomes not included in the total income.

2. Section 10A:
Special provision in respect of newly established industrial undertakings in free trade zones.

3. Section 11:
Income from property held for charitable or religious purposes.

4. Section 12:
Income of trusts or institutions from contributions.

5. Section 12A:
Conditions as to registration of trusts, etc.

6. Section 13:
Section 11 not to apply in certain cases.

7. Section 13A:
A special provision relating to incomes of political parties.

(II) 1. Exemptions of wealth-tax under Section 5 of Wealth-tax Act.

2. Exemptions of gift-tax under Section 5 of Gift-tax Act.

Complete Exemptions:

The items detailed in Sections 11 to 13 are excluded from the total income. They are neither taxed nor taken into account to determine the rate of tax on other incomes.

Types of Exemptions:

Exemptions provided in Chapter-III of the Income-tax Act, 1961, under section 10 may be of two types:

(1) Based on the nature of income, and

(2) Based on the character of the agricultural income, under section 10(1) and the income derived from trust property under section 10(11)

These two incomes are of first category while the income of local authorities are exempted under section 10(20) of the second category.

Significance of Exemptions and Deductions at-a-glance:

(A) Exemptions:

1. Acclerate the rate of saving, investments, production and capital formation;
2. Facilitate balanced economic development;
3. Advancement in science and technology;
4. Promotion of export trade;
5. Attract the flow of foreign capital, technical knowhow;
6. Promotion of education, sports, cultural and social amenities;
7. Development of research and technology.

(1) Accelerate the flow of Saving, Investment and Capital Formation:

The aim of every government is to fasten the tempo of economic growth. Faster economic development requires higher rates of capital formation. Huge amount of funds are to be provided from one or the other sources. In most of the underdeveloped countries, substantial portion of their Gross National Product (GNP) is being consumed by the increasing population, leaving only a minor part for saving and investment.

Foreign aid is another source of providing funds for investment and capital formation, which, however, is unrealiable and non-realistic.

Most of the underdeveloped countries have relied on the internal resources. Taxation policy of developing countries aims at providing the required revenues. Progressive rates of taxation, lower level of basically exempted income, over-inflationary trends and failling value of a rupee on the one hand and various incentives offered in the form of exemptions, deductions allowed on the other, restrict consumption and attract large scale savings and investments. Exemptions of certain incomes transmit surplus funds from private consumption to public sectors. Deductions, allowances, tax-holidays for investments in specified areas fasten the rate of capital formation and economic growth.

(2) Facilitate balanced Economic Development:

A country is said to be well-developed, provided its present and potential sources of income and wealth are evenly distributed. Tax concessions, exemption, deductions, allowances to new industrial units set up in industrially backward areas, for which one of the object of our industrial policy resolution is to remove the regional disparities and have a balanced economic development enabling the Government to undertake an alround development of the country. Exemptions, deductions, tax-holidays, etc., encourage alround industrial growth.

(3) Advancement of Science and Technology:

Exemptions of incomes received by the institutions established for undertaking research work in approved projects, deductions to the donors to such of the approved institutions and exemptions of income received by foreign technicians, all contribute to promoting and developing science and technology.

(4) Promotion of Export Trade:

Exemptions and deductions, tax-holidays extended to export-oriented units, industrial units set up in free-trade zones attract investment in production of export-goods and thereby increase export trade. Increase in export trade brings more foreign exchangez and improve the balance-of-payment position.

(5) Attracts flow of Foreign Capital, Technical Knowhow, etc.:

Exemptions of income earned by non-resident foreign investors by way of interest on investment, remuneration for technical services or royalty paid for technical knowhow, etc., attract large amount of foreign capital and technical knowhow, which is a key-factor in the industrial development of a country.

(6) Promotes Education, Sports, Cultural and Social Amenities:

Exemptions of income in the hands of institutions established with the object of promoting education, sports, culture, art or institutions established for philanthropic purpose, take care of promoting education, sports, culture, art and other social amenities in a Welfare State.

(7) <u>Development of Research and Technology in various sectors</u>:

Exemptions of income of institutions or associations for scientific research duly approved by the Central Government are exempted and deductions of such expenditure by a business, weighted deduction, etc., enhance the potential for scientific research in the country, resulting in developing of high technology.

(B) <u>Deductions</u>:

Deductions are normally permitted because they are in the nature of 'expenses to earn income and also because equal incomes do not necessarily represent equal taxable capacity under the Income-tax Act'. Almost all expenses actually incurred by the taxpayer to earn his income (subject to statutory limits) are allowed as deductions, the underlying principle being that the gross income earned by the taxpayer must be noted for taxation purposes. Sometimes deductions are also allowed to achieve certain social and economic objectives, e.g. National Defence Fund and the Prime Minister's Relief Fund. Exemptions mean permitting a minimum standard-of-living or some amount of money-income which do not reflect the taxpaying ability of the individual.

Deductions stand for an amount to be deducted from income in respect of an amount of expenditure incurred in earning a particular income. It is an act or process of deducting an amount sacrificed for earning a particular income. Thus, the cost of deriving any income is deducted from the respective heads of income under different sections.

Deductions are allowed from two angles: (1) for the expenditure incurred in earning an income; (2) as an incentive for directing certain payments/investments with socio-economic objectives.

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