CHAPTER ONE

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> "Indeed some kind of chart might be drawn up to indicate the close connection between length of British rule and progressive growth of poverty. That rule began with outright plunder and a land revenue system which extracted the uttermost farthing not only from the living but also from the dead cultivators. It was pure loot."
>
> – Jawaharlal Nehru

In the process of economic development of the 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 revenue and expenditure, i.e. public finance.

Public finance deals with the finance of the public as an organized group under the institution of the government. The finances of the government includes the raising and disbsursement of government funds; public finance deals with income and expenditure of the publc bodies – national, state or local – and the principles, problems and policies relating to these problems.[1]

Public finance is divided into: (i) Public Expenditure, and (ii) Public Revenue.

PUBLIC EXPENDITURE:

Public expenditure deals with various principles, effects and problems of expenditure made by the public authorities, i.e. the expenses which the government incurs for its own maintenance as also for the society and the economy, as a whole. These days, some governments are incurring expenditure to help other countries and that would also form a part of the total public expenditure. With expanding state activities, it is becoming increasingly difficult to judge what portion of the public expenditure can be ascribed to the maintenance of the government itself and what portion to the benefit of the society and the economy.

Kinds of Public Expenditure:

(a) Accounting Classification: Through this classification, the state executive maintains an effective control and checks over public expenditure and possible leakages and wastages, diversions and misappropriations. It may be a departmental classification or a classification according to the heads of expenditure.

(b) Productive and Jnproductive: Some expenditures are in the nature of investment and help the economy in improving its productive capacity. Jnder the 'laissez-faire' philosophy, the only productive public expenditure would be those which are incurred to create and maintain social overheads. Expenditures on administration,, defence, justice, law and order and maintenance of the State were unproductive.

(c) Transfer and Non-transfer Expenditure: An expenditure may be in the form of a payment, which is without corresponding transfer of real resources or their use by the State. Non-transfer expenditure is that by which the State pays for its purchases or for use of goods or services.

PUBLIC REVENUE:

Public revenue deals with the revenue raising activities of the public bodies and the various principles underlying therein. 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.

The estimates on revenue account have been grouped under two broad headings:

(1) Tax revenue, and

(2) Non-tax revenue.

1. Tax Revenue has been divided into:

(a) Taxes on income and expenditure. There are two types of income-taxes, 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 include central excise duties, customs duties and sales-tax, state excise duties, taxes on vehicles, etc.

2. The Non-tax revenue has been divided into:

(a) Fiscal and other services: Fiscal services relate to the revenue received by the central government from (a) currency, coinage and mint; and (b) other fiscal 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: The constitute the most important source of non-tax revenue and comprise interest on loans to States and Union Territories, interest payable by Railway and Postal Services, etc.

(c) Dividends and Profits: These relate to the profits of the Reserve Bank of India, profits of the nationalized banks, Life Insurance Corporation, public enterprises, etc.

"A tax policy aims at lessening inequalities through income at highest levels in only one form, which fiscal operations may assume in this sphere. An important complementary aspect lies in the part that public expenditure for the economic development and expansion of the social services like education and health may play in strengthening the positions of weaker sections of the country."[2] (Report of the Taxation Enquiry Commission, 1972).

An increase in the economic growth or an increase in a nation's physical product may come about either from more labour, more capital, better techniques or a combination of these factors, with natural resources treated as constant. The effects of taxation on economic growth, therefore, can be analyzed in terms of its influence on the labour supply on capital formation and on technological change or increased knowledge. There are atleast five ways in which the tax policy may affect the process of economic growth:

1. the level of aggregate demand will be determined by the automatic response of revenue to the economic growth, accompanied by expenditure trends;
2. the level of surplus or deficit 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 savings and investment;
4. specific structural characteristics will influence both total savings and investment and 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.[3]

The taxation on personal income, i.e. income-tax, was imposed in England in the year 1798 by William Pitt, so as to raise the funds needed by the British Government to meet the financial difficulties caused by the war with France. It was for the first time that a Royal Decree accorded equal treatment to all the taxpayers, in the sense that the rate was applied uniformly to each corner of income but the tax incidence was proportional. Right since its commencement, income-tax was never thought to be a permanent measure of taxation and as a result, during the subsequent years, it recorded a chequered career. The following condensed version of Simon's narrative ("Simon's Income-tax", second edition) reveals this aspect:

> "The final shape of the income-tax in the Napoleonic Wars was achieved by an Act passed in 1806. The rate of tax was increased and remained unchanged until the expiry of the tax in 1815. After the political revolution of 1830s, the only alternative was to restore the income-tax for three years only. The modern income-tax began its long, fruitful and uninterrupted career. Gladstone's expectation of the disappearance of the income-tax by 1860 was doomed to disappointment, for during the Crimean War (1855-56), the rate of income-tax rose. At the general election of 1873, Gladstone (had) promised the complete repeal of the income-tax, but the electors rejected his government on other issues and henceforth, the tax was regarded as an integral part of the country's permanent fiscal system."4

CANONS OF TAXATION:

Taxation is a major source of revenue of the government and, therefore, it has to keep in view various principles while imposing taxes on persons and commodities. Following are the canons of taxation given by Adam Smith:

(1) Canon of Equity: In the words of Adam Smith, "the subjects of every State ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities, that is, in proportion of the revenue, which they respectively enjoy under the protection of the State". In other words, every person will pay the taxes to the government in proportion to his "ability to pay". The Indian direct taxes like the income-tax and the wealth-tax are based on the canon of equity, or the ability to pay. Likewise, some commodity taxes in India 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 the tax and in what form the tax is to be paid to the government. 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 tax collection should minimum. If a major portion of the tax proceeds is spent on the collection of the tax itself, then such a tax cannot be considered as a good tax. The expenditure tax, for example, does not satisfy the canon of economy.[5]

CHARACTERISTICS OF A GOOD TAX SYSTEM:

A good tax system is the one which will satisfy both taxpayers and nation, as a whole, and also is convenient to both. The 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 wellknown, the 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, viz.

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 of the country. 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 luxury items will help to raise adequate financial resources for being ploughed 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 health.

(8) Minimum Social Advantage: The system of taxation is the best which is based on the principle of maximum social advantage.

(9) Widening of Tax Burden: The burden of the tax should be wide and if the taxpayers are more, the burden of tax to each will come to 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 national interest.[5]

Direct taxation is not a novelty in India, introduced by the British as too commonly supposed. The British Government, however, resorted to taxation as an instrument of fiscal necessity by introducing the Income-tax Act in India in 1860, following the financial exigencies faced by the Government as an outcome of the events of 1857. Although the imposition of the Income-tax of the Income-tax Act was considered to be a paramount basis so far as the Income-tax Act was considered and under the Government of India Act, 1919, the Income-tax Act was fully retained by the Central Government. The Government formally legislated the Income-tax Act in 1922, in order to consolidate and amend the law relating to the income-tax and the super-tax.[6]

In the Independent Democratic Sovereign Republic of India, the power to levy taxes is derived from the Constitution and as such, a review of the Constitutional provisions, in the context of examination of the direct tax structure, becomes indispensable. The Seventh Schedule to the Constitution of India provides for a List, which is further sub-divided into three separate Lists, viz. the Union List, the State List and the Concurrent List. The Union List, vide entry no.82, is directly concerned with taxes on income (other than agricultural income); entry no.85 deals with the corporation tax; entry no.86 deals with taxes on capital values of assets, exclusive of the agricultural land of individuals and companies, taxes on the capital of companies, which essentially pertain to taxes on wealth; entry no.87 pertains to the estate-duty in respect of property other than agricultural land.

The Estate-Duty Act of 1953, the Wealth-tax Act of 1957 and the Gift-tax Act of 1958, together with the Income-tax Act of 1961, govern the entire direct tax sphere.[7]

SCOPE AND SIGNIFICANCE OF THE STUDY:

The term 'direct tax' stands defined under Section (2) of the Central Board of Revenue Act (LIV of 1963). Accordingly, 'direct tax' means:

1. Any duty leviable or chargeable under:
    (i) the Estate Duty Act, 1953;
    (ii) the Wealth-tax Act, 1957;
    (iii) the Expenditure-tax Act, 1957;
    (iv) the Gift-tax Act, 1958;
    (v) the Income-tax Act, 1961;
    (vi) the Super Profits Tax Act, 1963;
2. Any other duty or tax, which having regard to its nature or incidence, may be declared by the Central Government by notification in the Official Gazette, to be a direct tax.[8]

The present study is concerned with the examination of the overall direct tax contribution and its role in the Union financial structure. It covers only three Acts, viz. the Income-tax Act, 1961; the Wealth-tax Act, 1957 and the Gift-tax Act, 1958.

In the fiscal system of a developing country like India, due to economic crises which will affect the economy of the country as a whole, leading to deficit finance, to recover this `gap, it is unavoidable to borrow from outside, which in turn, creates a larger deficit, because of the payment of interest on the borrowed money. Thus, the money to be invested in productive purposes is often diverted towards the payment of interest and to maintain the public expenditure. The deficit, therefore, is usually sought to be filled up with the levying of additional taxes, mostly the indirect taxes. In India's financial structure, indirect taxes occupy a vital place. The indirect taxes, however, tend to affect poor people more than the rich.

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.

An examination of the sources of revenue for the Central and State Governments, collectively as well as severally, reveals that the relative significance of the tax revenue has <u>declined slowly</u> but surely. Within the tax revenue, relative contribution of the direct taxes has declined steadily. The share of the direct tax revenue has declined from around 37% to 1950-51 to less than 15% in the budget estimates of 1990-91. In the case of central revenue only, the share of direct taxes (in the net tax revenue) has declined from 36% to less than 17%, while the share of direct taxes in the State tax revenue has declined from around 38% to about 11% during the same period. It is interesting to note that the tax:GDP ratio at the All-India level has gone up from 6.69 to 17.11 between 1950-51 and 1988-89. However, the direct tax revenue has remained nearly stable in relation to the GDP, whereas the ratio of indirect tax revenue has gone up from 4% to nearly 15% during 1950-51 and 1990-91.

The weakest aspect of the fiscal system in India is the administration of the fiscal operations. While concealment of the tax liability by taxpayers is a widely prevalent natural tendency, it is obviously the function of the tax administration to ensure that actual evasion is minimized.

The suggestions given by Dr.Raja J.Chelliah Committee about the global solution to the problems of administration are as follows:

1. Modernizing the administrative system in order to achieve better taxpayer control;
2. Correcting structural failures that result in an overlap of functions scattered or deficient guidelines and the lack of continuity and effectiveness of the process;
3. Promoting deconcentration.

OBJECTIVES OF THE STUDY:

Following have been set out as the objectives of the present study:

(1) To examine the overall contribution of direct tax and its role in the union financial structure;

(2) To make a comparative analysis of the total revenues vis-a-vis tax revenue, direct and indirect;

(3) To make appropriate recommendations with a view to improving the direct tax contributions;

(4) To offer such meaningful suggestions as may be appropriate.

METHODOLOGY OF THE STUDY:

The present research work is based exclusively on the **secondary data,** that is published sources. Accordingly, besides relying on the data published by the Reserve Bank of India and the reports of the various enquiry commissions appointed by the Government, the researcher has also drawn substantially from the comments and views of the tax experts and commentators as appeared in the print media. Exclusive reliance on the published sources was also warranted because of the comparative-investigatory nature of the present research endeavour.

LIMITATIONS OF THE STUDY:

The present research work deals with direct taxes' contribution to the union finances. Hence, the main limiting factors of the present study are:

1. that it takes within its fold only the direct taxes, viz. the income-tax, the wealth-tax and the gift-tax, but does not consider the contribution of the indirect taxes;
2. the researcher has used a wholistic approach to studying the problem under consideration; hence, the interpretation of the specific statutory provisions has been left out;
3. the study is based exclusively on the secondary data;
4. the study does not take into consideration the contribution of the direct taxes imposed/imposable by the States, e.g. agricultural income-tax, but concentrates on the direct taxes imposed by the union government only.

CHAPTER SCHEME:

The Dissertation is divided into Five Chapters. Chapter One deals with methodological aspects of the study. Chapter Two presents an analysis of union financial structure. Chapter Three focuses on the role of direct taxes in the union finances. Chapter Four presents a critical evaluation of the tax system and Chapter Five presets the conclusions and suggestions of the study. The Dissertation concludes with a comprehensive Bibliography.

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