CHAPTER TWO

UNION FINANCIAL STRUCTURE

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> Any efficient control apparatus has to rely primarily on the acceleration and the steering wheel and only minimally on brakes. Brakes have, no doubt, to be applied to avoid pitfalls and hurdles. But to impart speed to the economy, as we must, and to steer in the right direction, other levers of control have to be deployed such as competition, incentives and penalties.
>
> \- C.K.Jha.

2.1 Introduction:

In the present Chapter, the financial structure of the union revenues and the union expenditures for last three decades and the role of the tax revenues (both direct and indirect) have been considered. The present research deals with the contribution of the direct taxes and their role in the union financial structure. An attempt, therefore, is undertaken to analyse the statistical data in this behalf, which would reveal the financial position of the union exchequer.

2.2 Financial Structure of Union Revenues and Union Expenditure:

In order to examine the role of the direct taxation in the Indian tax structure, we shall study the direct tax trends, both in the pre-Plan period as well as during the Plan period. For analysing the direct tax trends in the pre-Plan period, we shall take the year 1938-39 as our starting point, since significant changes took place in the direct and indirect tax structure only affer that year. Before the Second World War, the Central Government mostly depended on commodity taxation for the bulk of its revenue. Of the total gross tax revenue of the Government of India in the year 1938-39 amounting to Rs.73.90, Rs.40.59 crores were contributed by customs, Rs.8.66 crores by central excise, Rs.15.78 by taxes on income, including corporation tax, and Rs.8.12 crores by the tax on salt. In percentage terms, customs represented 54.8% of the total tax revenue, excise duties 11.70%, taxes on income 21.40%, and salt 11%.

But the War brought about a fundamental change in the tax structure of India and the emphasis shifted from commodity taxation to direct taxation. Table 2.1 below shows the main changes in the tax structure as a result of the War.

Table 2.1

Percentage of total revenue

Particulars	1938-39	1944-45
Customs	54.8	15.7
Taxes on income	21.4	64.2
Excise Duties	11.7	15.0
Salt	11.0	3.7

Source: Suman, H.N.P.S., "Direct Taxation & Economic Growth in India", p.34.

It is seen from the above Table that the percentage of the commodity taxes to the total tax revenue stood at 77.5% in in the year 1938-39, but fell heavily to 34.3% in the year 1944-45. On the other hand, direct taxes which constituted 21.4% of the total tax revenue in the year 1938-39, gained in importance and the percentage went as high as 64.2 in the year 1944-45.

It should be noted that in almost all the countries of the world, direct taxes became relatively more important than indirect taxes during the War. The change in the relative importance of direct and indirect taxes in some important countries is shown in Table 2.2.

Table 2.2

Percentage composition of tax revenues

(in percent)

Countries	1938-39		1944-45	
	Direct taxes	Indirect taxes	Direct taxes	Indirect taxes
United States	53	47	86	14
United Kingdom	55	45	63	37
Canada	33	67	63	37
Australia	22	78	66	34
India	22	78	64	36

Source: Same as Table 2.1, p.35

As a matter of fact, in India, "it weas the exigencies of the World War that compelled greater resort to direct taxes...". As we know, the yield from income taxation is a function of two variables - the rate of tax and the level of income. During the War period, both increased and its proportion of the total tax revenue rapidly increased. Table 2.3 below shows the percentage of taxes to total revenues.

Table 2.3

Percentage of taxes to total revenue

Year	Percentage of direct taxes	Percentage of indirect taxes
1946-47	59.8	40.2
1948-49	50.2	49.8
1949-50	45.1	54.9
1950-51	36.8	63.2

Source: Same as Table 2.1; p.36

Direct Tax Trends during Plan Periods:

The tendency of declining importance of direct taxes has also continued in the subsequent period. This shown in Table 2.4 (on the following page).

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 is declining slowly but surely. It is seen from Table 2.4 that the contribution of the direct taxes to the centre, state and union territories in 1950-51 was 36.8% of the total tax revenue and the indirect tax contribution was 63.2% in the same year. By comparing the relevant data, it is also seen that the share of the direct tax revenue has declined from 36.8% to 14.92 in 1991-92, and the corresponding increase in the share of the indirect tax revenue rose to 85.09%. It is thus clear that the direct taxes are not as significant as indirect ones in the Indian tax structure.

Table 2.4

Tax revenue of the Government of India

(Rs.in crores)

Year	Total tax revenue	Direct taxes	Indirect taxes	% of (2) to (1)	% of (3) to 1
1950-51	627	231	396	36.84	63.16
1960-61	1350	402	948	29.78	70.22
1970-71	4752	1009	3743	21.23	78.77
1980-81	19844	3268	16576	16.47	83.53
1981-82	24142	4133	20009	17.12	82.88
1982-83	27242	4492	22750	16.49	83.51
1983-84	31525	4907	26618	15.57	84.43
1984-85	35814	5330	30484	14.88	85.12
1985-86	43267	6252	37015	14.45	85.55
1986-87	49539	6889	42650	13.91	86.09
1987-88	56676	7483	49193	13.20	86.80
1988-89	66925	9757	57168	14.58	85.42
1989-90	77693	11165	66528	14.37	85.63
1990-91(BE)	89,183	13,047	76,136	14.63	85.37
1990-91(RE)	89,303	13,397	75,906	15.00	85.00
1991-92	102896	15338	87558	14.91	85.09

Source: Government of India, "Economic Survey", 1991-92.

In 1990-91, direct taxes comprised 36.8% of the total tax revenue but the percentage dropped to 29.78% in 1960-61. Ever since, the percentage has generally been declining continuously. In 1980-81, it was 16.47% only; in the next year, it has increased to 17.12% and then again gone down to 16.49% in the following year and has declined further slowly to 14.91% of the total tax revenue. Thus, the percentage of the direct taxes to the total tax revenue has been showing a negative rate of growth as compared to the percentage of the indirect taxes to the total tax revenue, which has indicated a positive rate of growth in recent years.

Public Revenue:

The expenses which the government incurs for its own maintenance as also for the society and the economy, as a whole, refers to the expenditure of the public authorities on economic services, namely, agricultural and allied services, rural development, industry, minerals and energy. Social services like education, arts and culture, health and family welfare, social welfare and nutrition and also for the general services. The expenditure is both on the productive and the non-productive activities, the ultimate aim of the public expenditure being the promotion of the public welfare.

Principles of Public Expenditure:

Following are the principles, or rather canon, of public expenditure:

1. Canon of benefit: The public expenditure should be so planned that it may maximize social welfare. The government should spend its scarce revenue resources in such a way that the marginal social advantage will be the same on all the items.
2. Canon of Economy: The aim is to economise on the expenditure. The government should not spend more than what is

actually essential on a particular item. The expenditure should generally result in an increase in the production potential of the society. The authorities should avoid extravagances and wasteful expenditure.

3. Canon of Sanction: Public or authorized servants should not spend money unless they seek prior sanction and approval of the appropriate authorities. The limit on the expenditure of each government body must be fixed in advance. The aim of the principle is to avoid reckless expenditure.

4. Canon of Surplus: As far as possible, the authorities should not indulge in deficit financing. They should try to meet the current expenditure from current revenues.

5. Canon of Balance-Income and Expenditure: There should be a certain balance between governmental income and expenditure. The government budget should neither be a surplus-budget nor a deficit budget. If there is a surplus in the budget, it implies that the government is spending less than what it should; on the contrary, if there is a deficit in the budget, this implies that the government has been spending more than is necessary for the smooth functioning of the economy.

Objectives of Public Expenditure:

Following could be termed as the 'objectives of public expenditure':

1. <u>Maintenance of Public Law and Order:</u> This is of the supreme importance for the country. It implies not only the maintenance of the internal law and order, but also the defence against foreign aggression. Hence, a modern government invariably provides adequate funds for the maintenance of law and order within the country.
2. <u>Eliminating Socio-Economic Inequalities:</u> Public expenditure should be devised and planned in such a manner as to reduce such inequalities through redistribution of wealth in the society. The poor, the destitute and the handicapped people should be helped through such facilities as free-education, free medical-aid, cheap food and subsidized housing, etc.
3. <u>Increase in production:</u> The standard of living of a country depends upon its productivity. The public expenditure should be devised in such a manner as to give the maximum push to the productive process in the country. Enough funds should be spared for building up the infrastructural facilities in the country so as to help expand production.
4. <u>Promotion of Economic Stability</u>: A capitalist economy is characterized by periodical business fluctuations and economic instability. This lack of stability plays havoc with the functioning of the economy. Public expenditure plays a notable role in helping to achieve stability in the economy. It should be devised in such a manner as to go up automatically at a time

of depression and come down automatically during boom and inflation, to keep the economy on an even keel.

5. Promotion of Employment: To provide employment opportunities to the maximum number of people during depression, by applying the theory of Keynes.

The economic classification of the total expenditure in the central budget is shown in Table 2.5 (on the following page), from which it is clear that the expenses have increased by more than 500% over a period of decade, i.e. in 1980-81 , the total expenditure was Rs.22,495 crores, which has gone up to Rs.118,501 crores, showing an increase of about 526.78% over that of 1980-81.

Analysis of the expenditure against individual heads shows that in 1980-81, the total consumption expenditure was Rs.5,174 crores (or 23% of the total tax revenue), and although there is an increase in its quantum, its percentage-wise fluctuation is very less. Percentage-wise, expenditure on defence is getting reduced in recent years, it was Rs.3,571 (or 15.9%) in 1980-81, but it was Rs.16,227 crores (or 13.7%) in 1991-92. Other governmental administrative expenditures have remained, more or less, at the same ratio throughout the decade.

The gross capital formation expenditure also occupies a major portion, i.e. 40%, of the total expenditure about a decade back, but presently it has been reduced to 31.6%.

Table 2.5

Economic classification of total expenditure in central budget

(Rs.in crores)

Particulars	1980-81	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91 (RE)	1991-92 (BE)
1. Consumption Expenditure	5174 23.0	8130 22.6	9428 21.5	11210 21.1	14665 22.9	16551 23.5	18763 23.0	20784 21.9	23102 21.4	24655 20.8
(a) Defence	3571 15.9	5823 16.2	6647 15.1	7962 15.0	10439 16.3	11875 16.9	13237 16.3	14298 15.0	15643 14.5	16227 13.7
(b) Other Government Admin.	1603 7.1	2307 6.4	2781 6.3	3248 6.1	4226 6.6	4676 6.7	5526 6.8	6486 6.8	7459 6.9	8428 7.1
2. Transfer Payments (current)	6912 30.7	11436 31.8	14938 34.0	18347 34.5	21243 33.2	25380 36.1	31399 38.6	37877 39.8	46177 42.8	51207 43.2
(a) Interest payments	2253 10.0	4450 12.4	5646 12.9	7090 13.3	8648 13.5	10702 15.2	13347 16.4	16525 17.4	20316 18.8	25835 21.8
(b) Subsidies	1912 8.5	2886 8.0	4484 10.2	5070 9.5	5542 8.7	5976 8.5	7859 9.7	10862 11.4	10722 9.9	8789 7.4
(c) Grants to States and JTs.	1810 8.0	2526 7.0	2863 6.5	3922 7.4	4205 6.6	4962 7.1	5831 7.2	5725 6.0	7997 7.4	8883 7.5
(d) Others	937 4.2	1574 4.4	1945 4.4	2265 4.3	2848 4.4	3740 5.3	4362 5.4	4765 5.0	7142 6.6	7700 6.5
3. Gross capital formation out of budgetary resources	9012 40.1	14702 40.9	17551 40.0	21447 40.4	24320 30.8	25770 36.7	28977 35.6	33012 34.7	35727 33.1	37414 31.6
(a) Physical Assets	1907 8.5	3356 9.3	4123 9.4	4558 8.6	5905 9.2	5961 8.5	7056 8.7	8136 8.6	8633 8.0	9750 8.2
(b) Financial Assets	7105 31.6	11346 31.5	13428 30.6	16919 31.9	18415 28.8	19809 28.2	21921 26.9	24876 26.2	27044 25.1	27664 23.3
4. Others	1397 6.2	1720 4.8	1962 4.5	2078 3.9	3795 5.9	2603 3.7	2263 2.8	3376 3.6	2923 2.7	5225 4.4
5. Total Expenditure	22495	35988	43879	53112	64023	70304	81402	95049	107929	118501

Note: Figures in decimals are percentages to respective total expenditure.

Over the years, the rising and large revenue account deficits, despite continued tax efforts of the community, and mainly due to undue increases in the non-Plan, non-productive expenditure, especially on subsidies, should have been of real concern. There was unchecked profligacy in the mid-1980s; of which, one consequence has been that capital receipts have been used, especially since 1984-85, to meet these deficits and by end-March 1992, over one-quarter of the total debt of the Government of India is not covered by any assets. In total expenditure, non-Plan outlay formed 62% in 1984-85 and 67% in 1988-89. Estimates for 1992-93 show further rise to 71%. The revenue deficits in 1992-93 is placed at Rs.13,882 crores, i.e. about the same as the original estimate for 1991-92. It may also be noted the net rise in the RBI credit to the central government in 1991-92 was more than was estimated. Also, non-Plan expenditure in R.E. for 1991-92 is higher than was estimated. These facts should be as disturbing as fiscal deficit magnitude. In 1992-93 estimates, major subsidies remain higher than in R.E. for 1991-92. The fertilizer subsidy is Rs.5,000 crores, pending review by a Parliamentary committee into fertilizer pricing and subsidy. Non-tax revenue is placed 13% higher than R.E. for 1991-92.

Causes of the Increase in Public Expenditure:

1. Developmental Work by Modern Governments: The modern governments are taking so much efforts about an alround development of the economy under the Five-Year Plans. Millions of Rupees have been invested in agriculture and industry during past twentyfive years. As a result, there has been a substantial increase in public expenditure.

2. Increase in population: As is wellknown, population explosion in the country is the main cause of many of the problems associated with the retarded development pace of the country; because the government has to spend huge amount on meeting the primary requirements of the population.

3. Inflation: Inflation is the main cause of increase in the public expenditure. For last few years, the inflation was raging in double-digit figures, between 10 to 15% and only recently, it has come down to a single digit. Under the inflationary pressures, the quantum of public expenditure also goes up.

4. Expenditure on Law & Order and Defence Update: To maintain country's internal law and order and to continuously update its defence preparedness, it is necessary for the government to incur huge expenditure; which is necessary for holding in check the anti-social elements within the country and to counter the aggression from beyond the borders, respectively.

5. Interest payments: The payment of interest on money borrowed internally on the foreign debts also constitute a major item of government expenditure. It is seen from the above Table that at the beginning of the decade, interest payments were only Rs.2,253 crores (or 10%) out of the total public expenditure, which had, by the end of the decade, shot up to Rs.25,835 crores (or 21.80%) of the total.[5]

Role of Direct and Indirect Tax Revenue:

In almost all the countries of the world, direct taxes are becoming relatively more important than the indirect taxes. During the Second World War period, India also came in the 'general category countries' like Australia, Canada and the United Kingdom, and income taxation played an important role during the War years. The revenue yield from taxation on income is a function of two variables - the rate of tax and the level of income. During War years, the rates of income-tax, sur-tax and corporation-tax were increased and made more progressive. Also introduced were the Excess-Profits Tax, the Business Profits Tax and the Capital Gains Tax.

The reduction in commodity taxation came mainly through a heavy fall in customs revenue during the War years. This fall in the customs revenue was mainly due to three important reasons:

1. Cessation of trade with enemy countries and the countries

under enemy occupation;

2. Shortage of shipping for normal trade purposes, resulting from heavy war demands on the available shipping; and
3. Restriction on the imports of many commodities, with a view to conserve foreign exchange for more urgent requirements of the War.[6]

It is seen from Table 2.3 that in the year 1946-47, the direct tax revenue was 59.8% of the total tax revenue, but declined to 36.8% and further to 14.91% in the year 1991-92. An important observation in this connection is that the percentage of the direct taxes to the national income in India has not been showing an encouraging trend in recent years.

Tables 2.3 and 2.4 together indicate the role of indirect taxation. These taxes contributed 40.2% to the total tax revenue and have since been increasing rapidly in the subsequent years, to 63.2% in 1950-51, to 70.22% in 1960-61, 78.77% in 1970-71, 83.53% during 1980-81 and 85.59% in the recent years. This leads to the obvious conclusion that in recent years, the role of indirect taxation is much higher than that of the direct taxation.

Role of Tax Revenue : Indirect:

A redeeming feature of the Indian tax sysem is that despite a strong tilt towards indirect taxes, the overall incidence, in all probability, has remained progressive. The study of the tax incidence by Chelliah and Lal showed that the indirect taxes, as a proportion of household expenditure, show a steady increase with a rise in expenditure levels. However, a more recent study by Ahmed and Stern, which takes into account the tax subsidy incidents on inputs used indirectly through inter-industry linkages shows less progressivity than the earlier study.[7]

It is clear while observing Table 2.4, i.e. the contribution of indirect tax in the total net tax revenue in the year 1950-51, is Rs.396 crores or 63.16% of the total tax revenue. It had been jumped in the next decade to Rs.948 crores, or 70.22%, of the total tax revenue, i.e. in 1960-61 and again jumped and was reduced in the year 1970-71 to Rs.3,743 crores, or 78.77%. It shows that within two decades, from 1950-51 to 1970-71, the indirect tax contribution increased nearly ten times more than it was in 1950-51 and in 1980-81, it is Rs.16,576 crores, or 83.53% of the total tax revenue and in 1991-92, it is Rs.87,558 crores, or 85.09%, of the total tax revenue.

In an underdeveloped country like India, indirect taxation plays a very important role. The reasons of this importance are as follows:

1. In underdeveloped countries, proper books of account are not maintained. In such cases, it is easier to

collect indirect taxes than the direct taxes.

2. According to Prof.Levis, "the taxpayer usually does not know how much tax is included in the prices of the articles he buys; so, insofar as the disincentive effect of taxation is psychological, it can be avoided by using indirect rather than direct taxes".
3. The 'per capita income' is low; so, most people have come below the exemption level. Hence, there is no chance of direct taxes.
4. Due to the lack of savings and capital formation, most of the income spending for consumption purpose.
5. Indirect taxes can be made progressive to a certain extent and they can act as a powerful instrument to limit or to stimulate consumption and production of a particular commodity.
6. Indirect taxes are also regarded as anti-inflationary in underdeveloped countries, where the income-tax is paid only by a microscopic minority, commodity taxes have greater advantage to control inflation than taxes on income.[8]

Vertical and Horizontal Equity:

Equity here does not mean that each taxpayer has to pay equal amount of tax, but it means that the burden of tax must fall equally on all the taxpayers. The Vertical Equity and the Horizontal Equity in the taxation have been clearly distinguished. Vertical equity is concerned with how the tax liabilities are arranged among people whose circumstances are acknowledged to be different. In other words, those who are better off should pay more taxes and thus should bear a greater burden of taxation. Horizontal equity is derived from the application of the axiom that similar individuals should be treated similarly, i.e. 'equal treatment to equals'. All those persons who are placed in similar circumstances should bear the same burden of taxation; in other words, 'similar and similarly situated persons are treated equal'.

The difficulty in applying the principle of horizontal equity is that identification of 'similar circumstances' raises awkward problems of fact and of values. The most pressing problem of horizontal equity is to decide as to how the tax system should take account of the household composition and arrangements in defining 'similar circumstances'. In the Chelliah Committee Report, the 'guiding principles' towards this end are set out as follows:

1. The tax system and its burden should be acceptable to the prospective taxpayers;
2. The system should have moderate rates of taxes and should be broad-based;
3. The system should not encourage the generation of blackmoney;
4. The tax system must remain stable for a certain period of time, unless and until the economic conditions force

drastic transformation;

5. The laws should be as simple as possible and their objectives be absolutely clear;

6. Tax administration should be made more efficient.

As stated above, horizontal equity means to treat similar individual similarly. But no two individuals are ever likely to be in exactly the similar circumstances and the real issue is how to treat equally the people in dissimilar circumstances. One of the criteria that can be adopted is the similarity of income, i.e. equal income earning individuals should sacrifice to the equal burden of the tax imposed on them.[9]

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