CHAPTER THREE

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> Equality of taxation, as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person towards the expenses of government so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experienced from his.
>
> John Stuart Mll, in: 'The Principles Political Economy', Book VII

3.1 Introduction:

Taxation constitutes the most important source of revenue for the government, which 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 any person does not pay the tax, he can be punished by the government;
2. The tax is paid by the taxpayer to enable the government to incur certain expenses in the common interests of the society;
3. The 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;
4. There is no directly relationship between the tax paid by the person and the benefits that he may receive as a result of government expenditure.[1]

3.2 Direct Tax Contribution:

A direct tax is that tax whose burden is borne by the person on whom it is levied. He cannot transfer the burden of the tax to some other person. In other words, the 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 the incidence of tax falls on the shoulders of the consumers. Hence, the impact and the incidence fall on the same person in the case of income-tax. Hence, hence income-tax is a direct tax.

Income-tax, wealth-tax, capital-gains tax, gift-tax, property-tax and death-duties are the direct taxes, while sales-tax, customs-duties and excise-duties are the indirect taxes.

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

It is very difficult to say as to which type of tax is better - indirect or direct, because both have merits and demerits. As a matter of fact, there should be a proper blend of direct and indirect taxes in a good tax system. In developed countries, more emphasis is laid on direct taxes while in underdeveloped or developing countries, the indirect taxes receive greater attention from the authorities. It may be pointed out that indirect taxes have a special role to play in the developing countries, which are determined to achieve a faster rate of growth. Direct taxes taken alone cannot provide the requisite financial resources to the government.

Table 3.1 (on the following page) shows the position of each of the direct taxes contribution to the union financial structure.

3.3 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. The 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.

Short History of the Income-tax Law:

The tax on income was levied for the first time in India in the year 1860 under the Income-tax Act. This Act followed the pattern of law as it was in force in England then. Between 1860 to 1886, various amending Acts were brought out and finally, in 1886, the Act of 1860 was redrafted

Table 3.1

Union Direct Tax Contributions

(Rs.in crores)

Year	Total direct tax	Income tax	Wealth tax	Gift tax	Estate duty	Percentage to total direct tax revenue			
						Income tax	Wealth tax	Gift tax	Estate duty
1950-51	357	85	-	-	-	23.8	-	-	-
1960-61	730	80	8	1	3	10.96	1.09	0.14	0.41
1970-71	2451	114	15	2	8	4.65	0.61	0.08	0.33
1980-81	9388	504	67	7	16	5.37	0.71	0.07	0.17
1981-82	11573	459	78	8	20	3.97	0.67	0.07	0.17
1982-83	13056	438	90	8	20	3.35	0.69	0.06	0.15
1983-84	15476	528	93	9	26	3.41	0.60	0.05	0.16
1984-85	17694	696	108	11	24	3.93	0.61	0.06	0.14
1985-86	21180	663	153	12	23	3.13	0.72	0.06	0.11
1986-87	24318	717	174	9	14	2.95	0.72	0.04	0.06
1987-88	28337	761	120	10	9	2.69	0.42	0.04	0.03
1988-89	33805	1492	122	7	6	4.41	0.36	0.02	0.02
1989-90	37853	1082	179	8	4	2.86	0.47	0.02	0.01
1990-91	45352	1439	190	2	3	3.17	0.47	0.004	0.006
1991-92	50495	1559	230	9	2	3.09	0.45	0.02	0.004

Source: Compiled from Agarwal, A.N., et al., "Economic Information Year-Book 1991-92", New Delhi, National Publishing House.

and named the 'Income-tax Act, 1886'. It was eventually replaced by the Act of 1918. The new Act, however, enjoyed only a brief span of life and was replaced soon by a more comprehensive Act in 1922. Extensive amendments were brought about in the year 1939. The Government decided to redraft and simplify the same. Accordingly, in 1956, the Government appointed the Law Commission, which submitted its report in September 1958. The present Act, that is, the Income-tax Act of 1961, emerged out of the deliberations of the Law Commission, the Direct Taxes Administration Enquiry Committee, and the Ministry of Law. The basic structure of the law, however, has remained unchanged. The present Income-tax Act is largely a simplified and re-arranged version of the 1922 Act, as is apparent from the preamble to the 1961 Act.[3]

The beginning of the Second Five Year Plan, with its ambitious expenditure programme, necessitated an examination of the source of additional tax revenue, which would meet the requirements of the plan. Accordingly, in January 1956, Prof.Nicholas Kaldor of Cambridge University, was invited by the Government of India to investigate and suggest changes in the Indian tax structure. Prof.Kaldor stated, "I am strongly of the view that the developments of the last 15-20 years, which imposed (nominally) fantastically high marginal rates of tax while permitting the continuance of wide loopholes for tax avoidance are highly pernicious in character". According to him, "India, like most western countries, has been in the grip of vicious circle as far as progressive taxation is concerned. Evasion and avoidance by cutting down potential revenue led to higher nominal rates of taxation and this, in turn, has led to further evasion and avoidance and still higher rates. It is a vicious circle of charging more and more on less and less. The prime requirement is that to breach that vicious circle".

According to Nicholas Kaldor's suggestions, the base of direct taxes in India should be broadened. For this purpose, an annual tax on wealth, the taxation of capital gains, a general gift tax and a personal expenditure tax should be introduced.

Accordingly, as recommended by Prof.Kaldor in the sphere of direct taxation, the capital gains tax was introduced in 1956, the wealth-tax and personal expenditure tax were introduced by 1957-58 budget and the gift tax came in the budget of 1958-59.

Objects and Reasons of Income-tax Act, 1961:

The following statement of the objects and reasons opens the Income-tax Bill, 1961, which was introduced in the Lok Sabha:

"The Income-tax Act, 1922, has been subjected to innumerable amendments since the passing thereof. It was considerably revised in 1939 by Act-VII of 1939 and between the passing of Act of 1939 and 1956, the Act had been amended not less than twentynine times and each of these amendments had been of considerable importance. The result of all these amendments was that the Act required revision with a view to simplification and the Government, therefore, decided in 1956, to refer the Act to the Law Commission with a view to its simplification, the basic structure of the Act remaining unchanged. The report of the Law Commission was received by the Government in September 1958, but in the meanwhile, a Committee called the Direct Taxes Administration Enquiry Committee, had been appointed by the Government to consider measures designed to minimize inconveniences to the assessees and to prevent evasion of income-tax. The report of the Committee was received in 1959, ...

In the present study, an attempt is made to study the overall contribution of direct taxes and also the contribution of each of the direct taxes to the Union exchequer and its position since 1950-51 to 1991-92, which had been shown in Table 3.1

Table 3.1 shows that the next tax revenue of the central government in the year 1950-51 was merely Rs.357 crores, which has gone upto Rs.50,495 crores in the year

1991-92, which is almost 140 times increase. Now it is being attempted to assess as to how far the individual direct taxes contribute to the total tax revenue.

It is also seen from Table 3.1 that the income-tax had contributed 23.8% (Rs.85 crores) in the year 1950-51, but it had come down to 10.96% in a decade. The contribution of the direct tax revenue in 1960-61 was only Rs.730 crores and has been declining since then, so much so that in 1991-92, it had contributed only 3.09% (Rs.1559 crores). A comparison of this statistics shows that even though the contribution of the income-tax in terms of quantum is on the increase, its percentage in the total revenue of the government has been going down steadily. This is because the indirect tax contribution has come to contribute a major part of the government's revenue, from Rs.229 crores in the year 1950-51 to Rs.37,642 crores in the year 1990-91.

3.4 Wealth-tax:

Wealth-tax is a tax which is imposed on an annual basis on the net wealth of the individuals and the Hindu undivided families. It is a recurring tax and as such, its rates have been kept low. It is also known as a 'tax on capital' or property taxation. Wealth-tax had its origin in the recommendations made by Prof.Nicholas Kaldor in his report on the Indian tax reforms in the year 1956 and its purpose has been explained in 3.2 above.

Prof.Kaldor's Report "Indian Tax Reforms" indicates that he was requested by the Government of India to review the Indian tax structure, primarily with reference to the personal and business taxation and having regard to "the larger dimension assumed by the problems of resources for the Plan". The aspects relating to the reduction in equity of wealth, therefore, was not at all a factor when Prof.Kaldor undertook this task but his objective was primarily confined to the augmentation of the government revenue for proper financing of the Plan. Prof.Kaldor has observed:

> "It is inequitable because the present base of taxation of 'income', as statutorily defined, is defectively biased as a measure of taxable capacity and is capable of being manipulated by certain classes of taxpayers. It is inefficient because the limited character of the information furnished by the taxpayers and the absence of any comprehensive reporting system on property transactions and property income makes large-scale evasion through concealment and under-statement of profits and property income relatively easy".[4]

He felt that there should be a self-checking in character; eliminating, or considerably reducing, the scope of tax evasion. He suggested the maximum rate of tax on wealth should be 1.5%, in the excess of he capital value over Rs.15.0 lakhs.

<u>Objects and Reasons</u>:

The preamble of the Wealth-tax Act, 1957, explains its objects and reasons as follows:

> "The object of this bill is to impose an annual tax on the net wealth of individuals, HUFs and companies. The proposed tax is an important constituent of an integrated tax structure which the Government has been aiming at for some time. With income-tax, estate-duty and a tax on capital gains already in existence and with the addition of wealth-tax and a tax on large personal expenditure, the direct taxes will form a composite system made up of complementary elements. Apart from the fact that a composite tax system of this type helps to specify the criterion of the ability to pay, it is consistent with the avowed goal of the attainment of socialistic pattern of society...".[5]

The Bill finally received the President's assent on 12th September 1957 and the Act became operative retrospectively from the first day of April, 1957.

Now it is attempted to study the contribution of the wealth-tax in the year 1960-61 was 1.09% (Rs.8.0 crores) in the total tax revenue. During the next decade, the percentage has come down to 0.61% (Rs.15.0 crores) of the total tax revenue. In the succeeding years, there was no much variation but in the year 1991-92, it contributed merely 0.42% (Rs.190 crores) to the total tax revenue. Actually, the volume of the wealth-tax revenue has increased by about 19½ times over what it was initially but its percentage to the tax contribution has declined by more than 50%. Through a comparison of these statistics, it can be concluded that, in future, the percentage of wealth-tax revenue in the total tax revenue is going to be still less, because the indirect tax revenue will be contributing much more.

3.5 Gift-tax:

Gift-tax and death-duties have a significant role to play in the economies of the underdeveloped countries. Gift-tax may be used as a supplement to death-duties. Generally, people pass on their property as gifts in order to avoid payment of the estate-duty. A gift-tax can introduce equity in the tax structure, check capital dissipation by reducing wasteful capital expenditure on a large number of occasions when the gifts are made.

Prof.Kaldor's Recommendations:

Prof.Kaldor had put forth a proposal for a single integrated tax on gifts of all kinds. The general gift-tax proposed by Prof.Kaldor included the present taxes on bequests and inheritance as well as a charge on all gratuitous transfers of property as gifts which may not be taxable. Prof.Kaldor advocated a single integrated general gift-tax "on the grounds of equity, expediency and administrative efficiency" from the point of view of equity and further proposed that taxes should be levied on all gratuitous transfers of property - irrespective of the mode of transfers.

Another reason for an integrated system of gift taxation would be to eliminate all chances of evasion and avoidance. Towards this end, Prof.Kaldor suggests that the temptation to dissipate one's capital can be considerably reduced if a rich person is allowed to spread his estate on a large number of beneficiaries and at different times, through gifts 'inter-vivos'.

Pro.Kaldor comes to the conclusion that there should be a uniform tax on all gratutious transfers whether they are bequests or gifts. The legal liability for such a tax should be placed on the beneficiary and not on the donor. Further, he would have liked the rate of progression to be dependent neither on the size of the gift nor on the wealth of the donor but on the total wealth of the recipient, that is, his net worth including gifts. Such a single integrated tax on all types of gifts would make tax evasion very difficult.

Objects and Reasons:

The objects and reasons of the Bill introduced in the Lok Sabha in 1958 were as under:

"The object of this bill is to levy a tax on gifts by individuals, Hindu undivided families, companies and associations of persons. Gift from one person to another provides a convenient tool of avoiding or reducing liabilities to estate duty, income-tax, wealth-tax and expenditure-tax. The only objective method of checking such attempts at evasion or reduction of tax liability is by levying a tax on gifts. With the introduction of this tax, the integrated tax structure, which the government have been aiming at will be completed.".[6]

Hence, the Gift-tax Act was passed in the Lok Sabha to come into force as the Gift-tax Act of 1958; which is framed on the basis of the New Zealand's Gift-Duties Act, 1955. The gift-tax legislations are in vogue in the United States, Canada, Australia, New Zealand, Sri Lanka and other countries.

At this juncture in the present study, an attempt is made to know the position of the gift-tax's contribution to the union exchequer. As is seen from Table 3.1, the contribution of the gift-tax in the year 1960-61 was Rs.1.0 crores (0.14%) to the total tax revenue. It is also seen that this quantum has doubled to Rs.2.0 crores in about a decade, but the percentage-wise contribution has gone down to 0.08% by 1970-71. In the succeeding years, the same relation has continued; it was Rs.7.0 crores (0.07%) in 1980-81 but had slid down to merely Rs.2.0 crores (0.004%) in the year 1990-91. As such, it is seen that the contribution of the gift-tax to the union tax structure is becoming negligible.

The above analysis thus shows how the contribution of the direct taxes, as a whole, has come down in recent years; especially the gift-tax and the wealth-tax are becoming increasingly insignificant. Same is the case with the Estate-duty which had contributed Rs.3.0 crores (0.41%) in the year 1960-61, but has contributed merely 0.006% share to the total tax revenue in the year 1990-91.

Fiscal Neutrality:

A neutral tax system is the one which seeks to raise revenue in ways which avoid the distortionary substitution effects. It is designed to minimize, as far as possible, the impact of the tax structure on the economic behaviour of agents in the economy. A major function of this tax system is to encourage good things and to discourage bad things. We should rather be content if a tax system can achieve its basic function of raising revenue and redressing inequalities of income and wealth without doing too much damage in the process. This is a good deal less than an ideal tax system, but it is a good deal better than what we have at the moment.

Fiscal neutrality does not imply that the tax system has no effect on behaviour. No tax system which collects revenue can have that property. A structure approaches fiscal-neutrality to the extent that it avoids high marginal rates of tax and does not impose very different rates of tax on essentially similar activities.

The current vogue (mode or fashion) for fiscal neutrality involves a retreat from an older view that taxation is a central instrument of social and economic policy. The function of the tax system is in the process of realizing revenue to encourage the good and discourage the bad.

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