CHAPTER ONE

CORE CONCEPTS AND RESEARCH DESIGN

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1.1 HISTORICAL BACKGROUND:

From the time immemorial, Indian rulers have made the non-agricultural classes contribute their share of the expenses of the State. To the Indian mind, in general, this appeared only just fitting and to be contentedly borne. As such, direct taxation is not a novelty in India introduced by the British as too commonly supposed. The British Government, however, resorted to direct 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 Act was considered to be a temporary revenue measure at that time, however, in 1886, a bill was introduced in the Legislative Assembly as a result of which, income-tax became a permanent feature of the Indian tax system, was concerned and under the Government of India Act of 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.

Consequent upon the recommendations made by the Law Commission in 1958 and the Direct Taxes Administration Enquiry

Committee (Mahavir Tyagi Committee) in 1959, the Government of India passed the Income-tax Act, 1961, in September, 1961, replacing the earlier Indian Income-tax Act of 1922. The said Act came into force with effect from April 1, 1962. Since then, several amendments of a far-reaching importance have been made in the Income-tax Act from time to time. The Income-tax Act, 1961, which was brought into force with effect from 1st April, 1962, had been amended and re-amended much more drastically and at shorter intervals during the fifteen years of its existence than the earlier Act was during the 40 years of its existence from 1922 to 1962. However, the basic provisions of the Income-tax Act should not be subjected to such frequent changes and only the rate structure of the tax may be altered from year to year by Annual Finance Acts.

Taxation, in general, and direct taxes, in particular, are resorted to by the central government for attaining the objectives of resources mobilization for planned economic development and redistribution of income with a view to reduce the inequalities of income. Various types of direct tax laws have been in force for a long time and have been amended from time to time. Yet, they neither appear to have contributed significantly to the economic development nor have they been of help in reducing the income inequalities in India. As such, a critical examination of the direct tax laws and proposing of a scheme of restructuring and reforming the direct tax laws have become absolutely necessary.

Taxea are unrequited compulsory payments collected primarily by the central government. The central and the state governments in India raise their tax revenues largely from two main sources:

(a) direct taxes on individuals and firms, and

(b) indirect (commodity) taxes on goods and services.

Direct taxes include taxes on personal and company income as well as other direct taxes consisting mainly of the social security contributions, payroll taxes and taxes on property and wealth. Indirect or commodity taxes include domstic taxes, such as broadly-based taxes on turnover, value-added and sales as well as excises on specific goods and taxes on international trade, namely, import duties, export taxes and cesses. So, in practice, though, taxes remain the principal sources of income for the central government.

1.2 CONCEPT OF TAX REFORM:

Taxes provide revenues to finance public spending and influence savings, investment allocations and the structure of production. The level of revenue collection helps to determine whether the country can finance public sector capital formation, maintain its infrastructure and provide for an adequate level of health and education services. In general, income-taxes, taxes on foreign trade and taxes on goods and services (sales and excise taxes) each account for about one-third of revenues.

Although tax patterns differ across countries, tax-to-GDP ratios in developing countries are in the 10 to 20 percent range, about half of the levels of the industrial countries whereas expenditure levels are in the 20 to 30 percent range, much closer to the levels of industrial countries. Many tax systems in the developing countries do a poor job of collecting revenue and introduce large distortions into the economy. Weak tax administration leads to widespread tax evasion, which also fosters income inequally.

The objective of tax reforms is to raise revenue and reduce the costs of tax-induced distortions. Recent reforms have emphasized revenue adequacy, horizontal equity, simplicity and neutrality and compatibility between the tax system and the administrative capacity. The main objective has been to broaden the tax-base so that the structure can be simplified and the tax rates lowered, thereby reducing tax-induced distortions and evasion. For taxes on goods and services, base-broadening implies a shift from trade taxes to consumption taxes such as a value-added tax, setting the central rate in the range of 10 to 20 percent. For income-taxes, this can be achieved by reducing exemptions and lowering the top marginal rates to between 30 and 50 percent. Further, selective excise taxes on luxuries and non-essentials can simultaneously enhance revenues and increase the progressivity of the tax system, without significant efficiency losses.

Comprehensive tax reform can work. In Jamaica, Malawi and Mexico, tax reforms have limited the use of selective tax breaks and have also raised revenues by widening the tax-base rather than by increasing the tax rates. In countries, such as Indonesia, value-added tax has been effective in raising revenue and reducing distortions. By replacing cascading sales-tax, it has removed the burden of double taxation on final goods and of indirect taxation on exports and investments.

1.3 NEED FOR TAX REFORMS:

The need for stabilization and adjustment of an economy through fiscal policies has become a necessity all over the world and attempts are always made to improve external and internal economic imbalances through such prudent policies. The major revenue and resource mobilization is always attempted through tax policies, which are the main contributors to the national exchequer. Direct and indirect taxes form a significant portion of the aggregate revenues of the central cauldron. The percentage of tax contribution to the total revenue, the percentage of direct and indirct taxes to the tax revenue assume significance from various points of view and their implications have also wider interpretations. Experts in public finance through their empirical findings, however, have drawn uniform inferences as regards the impact on the incidence of direct and indirect taxes in general. In India, studies pertaining to this area have revealed that the contribution of the direct taxes to the financial pool have manifested a lukewarm response. There may be various reasons for such behaviour; however, the lack of elasticity and the buoyancy of direct taxes necessitate the need for the tax reforms. This fact can be confirmed by the single fact that hardly less than 1 percent of the population shares the direct taxes whereas the rest of the population remains untouched out of the tax net. The following comments culled out of the observations of the Raja Chelliah Committee on Tax Reforms make an interesting reading.

By international standards, the level of taxation in India is fairly high. The ratio of the tax revenue of government (centre and the states taken together) to GNP ("the tax ratio", as it is called) currently stands at a little over 19 percent. According to the World Bank's analysis, for countries with similar per capita income, the average tax-ratio is around 12-13 percent. At the time when the country launched its First Five Year Plan, the tax ratio was less than 10 percent Even in 1970-71, it was less than 12 percent. Sustained efforts towards raising resources for the government through taxation in the last two decades have pushed up the ratio of taxation to its present level as is evident from Table 3.1 (on the following page).

Table 1.1

Combined tax revenue receipts of the Centre, State and Union Territories

Financial year	Gross domestic product at current prices	Combined tax revenue	Col.(3) as percentage of col.(2)
1960-61	15254	1350	8.85
1961-62	16097	1543	9.59
1962-63	17212	1865	10.84
1963-64	19671	2325	11.82
1964-65	22981	2599	11.31
1965-66	24063	2922	12.14
1966-67	27389	3261	11.91
1967-68	32187	3456	10.74
1968-69	33943	3759	11.07
1969-70	37328	4200	11.25
1970-71	39708	4752	11.97
1971-72	42248	5575	13.20
1972-73	46473	6436	13.85
1973-74	56954	7389	12.97
1974-75	67039	9223	13.76
1975-76	71201	11182	15.70
1976-77	76536	12332	16.11
1977-78	87351	13237	15.15
1978-79	93880	15528	16.54
1979-80	102442	17683	17.26
1980-81	122427	19844	16.21
1981-82	143216	24142	16.86
1982-83	159395	27242	17.09
1983-84	186723	31525	16.88
1984-85	208577	35813	17.17
1985-86	233476	43267	18.53
1986-87	259055	49539	19.12
1987-88	294266	56976	19.36
1988-89	351724	66925	19.03
1989-90(RE)	395143	76762	19.43

Source: Ministry of Finance, 'Indian Economic Statistics' (Public Finance)

This impressive rise in the tax ratio has come about more through the changes made in the base and the rates of the taxes from year to year than from an automatic increase in response to changes in incomes and prices.

Table 1.2

Growth rate of central taxes and income
(1970-71 to 1990-91)

(per cent)

Item	Average annual growth rates		
	1970-71 to 1979-80	1980-81 to 1989-90	1970-71 to 1989-90
Corporation income-tax	14.42	17.15	15.79
Income-tax other than Corporation income-tax	12.76	14.83	13.80
Major direct taxes	13.25	15.61	14.43
Customs duties	20.96	20.03	20.49
Excise duties	14.10	14.31	14.20
Total tax revenue	15.29	16.22	15.75
Gross domestic product (GDP)	12.04	15.58	13.81
Non-agricultural GDP	13.33	16.50	14.92

As shown in Tables 1.2 (above) and 1.3 (on the following page), the tax revenues of the government (centre and states combined), roughly two-thirds (67%) are collected at the central levels. The proportion seems to have remained steady over the years. The ratio of central tax revenue to GDP has gone up from 8 percent in 1970-71 to nearly 13 percent in 1989-90 as the aggregate tax ratio has moved up from 13 percent to 19 percent during the same period. Over the 20 years 1971-90, central tax revenues (gross) grew at the rate of 15.8 percent per annum as against the growth rate

Table 1.3

Estimates of buoyancy of different taxes during 1970-71 to 1989-90

Item	Buoyancy with respect to GDP			Buoyancy with respect to NAGDP		
	1970-71 to 1979-80	1980-81 to 1989-90	1970-71 to 1989-90	1970-71 to 1979-80	1980-81 to 1989-90	1970-71 to 1989-90
Corporation income-tax	1.317	0.949	1.060	1.157	0.877	0.966
Income-tax other than corporation income-tax	1.054	1.140	0.889	0.923	1.052	0.808
Major direct taxes	1.182	1.028	0.970	1.036	0.950	0.883
Excise duties	1.224	1.066	1.069	1.075	0.987	0.974
Customs duties	1.564	1.492	1.521	1.393	1.387	1.385
Total central tax revenue	1.295	1.184	1.167	1.136	1.097	1.063

of 13.8 percent in GDP and 14.9 percent in the non-agricultural GDP. The growth rate has been faster during the 1980s than in the 1970s (16.2 percent as against 15.3 percent). However, the buoyancy of the central taxes with respect to GDP registered a decline, though slight, during the 1980s compared to the 1970s (1.2 as against 1.3). Direct taxes consisting mainly of the income-tax, personal and corporate, had a slower growth than that of non-agricultural GDP. During the entire period of 1970-71 to 1989-90, major direct taxes registered a growth rate of 14.4 percent per month, while the non-agricultural GDP grew at the rate of 14.9 percent. The gap between the growth in the direct taxes and that of non-agricultural GDP has widened during the 1980s (15.6 percent as

as against 16.5 percent).

Other relevant statistics released by the World Bank reveals that the revenue from taxes on income in case of India accounts for 21.3 percent in 1972, which has fallen to 15.4 percent in the year 1990. It also confirms that in case of some of the other Asian countries like Indonesia, the revenue has gone up to 157.0 percent in 1990. In case of India, there is another dichotomy that while the total current revenue as a percentage of the GNP has increased from 10 percent (in 1972) to 15 percent (in 1990), the tax revenue, as a percentage of the GNP, has substantially declined during the relevant period. These are some of the diverse features that necessitate the tax reforms.

Revenue from the principal direct taxes collected at the centre as a proportion of non-agricultural GDP has declined from 3.95 percent in 1970-71 to 3.70 percent in 1989-90. The decline has been sharper in the non-corporate income-tax (from 2.20 percent to 1.90 percent). Excise duties recorded a slower growth than the direct taxes during the reference period of two decades as a whole, but customs duties have grown steadily at more than 20 percent during the period. As a result, the ratio of customs duties to GDP has gone up from 1.32 percent in 1970-71 to 4.56 percent in 1989-90. Union excise duties, as a proportion of GDP, have also increased but not to the same extent (4.4% to 5.7%).

In the total gross tax revenues of the centre, customs and excise duties taken together account for about 78 percent while major direct taxes contribute less than 20 percent.

Worldwide, tax reform has become a central item or the political agenda of all governments. In America, the high tax rates were reduced under the Tax Reform Act (28 percent under the Reagan Administration). The Government of New Zealand has introduced radical tax reforms for broadening the tax base, reducing the tax rates and simplifying the tax structure. The process of tax reform is at its beginning, not its end; so, a political willingness has become an economic necessity.

The reform of taxes on personal and company incomes will be necessary to enhance the revenue and efficiency of a tax system. With fiscal deficits high and access to new borrowings limited, there is little scope for deliberate reduction in taxation in the near future. Whether taxes can be raised to cut fiscal deficit depends on the existing structure of taxes and the period over which the deficit reduction is to occur. Where tax bases are narrow, a rapid increase in revenue will necessitate higher rates. But in some cases, higher rates will eroce the tax base through evasion. In other cases, they will cause inefficiencies in economic behaviour, especially if the changes rely on administratively convenient measures such as trade taxes. In contrast, carefully designed tax reform can reduce the cost of raising additional revenue and ensure that tax policy complements other policies.

In the absence of fiscal deficits, tax reforms may be necessary, especially when price regulations and barriers to market competition are being removed or where there is a case for rectifying an accumulation of ad hoc distortionary tax measure. Recent tax reforms in developing countries have focused on reducing tax-induced distortions and on simplifying tax administration. Reforms are long term but not permanent. No system of taxation can be perfectly neutral with respect to allocation. Tax policy ignores distributional concerns. The balance between the various parameters is a matter of changing priorities and constraints. Where the growth of income is adequate, equity can be given greater weight through expansion of taxes on income. However, where slow income growth and limited administrative capacity are of greater concern, taxes on consumption may need to be given preference. The complexity of these issues, some general prescriptions can be gleaned from recent experience. Clearly their application will vary from country to country.

As the World Bank implores:

- Simplify the design of tax instrument, with fewer rates and fewer adjustments to the base; in particular, eliminate or streamline special tax incentives for investment, production and trade;

- Strengthen tax administration to improve collections and facilitate the shift in the tax structure from reliance on higher tax rates to reliance on producer tax base;
- Avoid taxing the poor.

Thus, the need for the tax reform has global significance. Yet, it should be firmly rooted in pragmatism, because in a developing economy, the objectives of tax policy include:

(i) raising of resources for development;

(ii) raising the rate of savings and investment;

(iii) curtailment of consumption, particularly of conspicuous consumption, to control inflationary tendencies;

(iv) reduction of inequalities in income and wealth;

(v) promotion of economic stability.

To make the tax policy more appropriate and conducive to the needs of development at every stage of economic development, it has to be integrated with the development policy of the country.

1.4 OBJECTIVES OF THE STUDY:

In contemporary India, direct tax policies are implemented by the Union Government through the Income-tax Act, 1961; the Wealth-tax Act, 1958; the Gift-tax Act, 1958; and the Expenditure-tax Act, 1957. These legislations have a long historic background. The taxes are collected on the basis of implementation of these legislations. As the fiscal needs of the modern welfare state undergo changes from time to time, the tax policy and tax legislation too have to unedergo commensurate changes. As such, the Government is always anxious to uptodate its tax legislations with a view to reform, simplify and rationalize the tax structure from time to time. Towards this end, the Government of India had appointed several Committees and Commissions over the years. The objectives of the present study, therefore, are:

1. To take a stock of the reforms initiated by the Government from time to time;
2. To examine and evaluate the achievements in this area;
3. To offer suggestions on the basis of the conclusions drawn from the study.

1.5 SCOPE OF THE STUDY:

The impact and incidence of taxes in general and those of direct taxes in particular reveal in different dimensions. The objectives of such taxation also possess peculiar characteristics. The direct taxes are levied and collected by varicus authorities such as the central government and the state government as well as the local authorities. The scope of the subject, therefore, to be distinctly earmarked. The present discussion, therefore, is confined to the direct taxes falling within the jurisdiction of the central government. It includes tax on income, tax on wealth, tax on gifts and tax on expenditure. All these taxes are being collected under separate legislations passed by the Parliament. Therefore, the research is confined to those taxes and the reforms introduced during the post-Independence period.

1.6 METHODOLOGY ADOPTED FOR THE STUDY:

Research in taxation covers areas such as economics as So far as the methodology is concerned, the conventional research pattern at times becomes difficult because of the secrecy of the subject. An attempt in this field, therefore, has to be made through the secondary data such as library books, reports of various committees such as Bhootalingam Committee, Wanchoo Committee, Choksi Committee published by the Government and also to use authentic commentaries and textbooks on this subject and finally, such other periodicals and magazines specifically devoted to the subject. The present research work, therefore, is entirely based on the **Library Research Method** and draws heavily from the **secondary data.**

1.7 LIMITATIONS OF THE STUDY:

The research relating to tax reforms is a continuing process and it always has a beginning, but no end. It also is a vast area covering a number of direct taxes such as income-tax, wealth-tax, gift-tax, etc., and covers longer periods during which the reforms take place. Besides, tax reform, though is concerned with tax policies connected with economic issues, still the implementation of such policies is resorted through appropriate legislations. Thus, the subject has a very wide range.

The present study dealing with tax reform, therefore, is limited to the latest report submitted by the Raja Chelliah Committee, although a brief review and an appraisal of the reports of earlier Committees has also been attempted. The study is further limited to the critical evaluation of some of the major recommendations made by the Raja Chelliah Committee. Therefore, the scope of the study is confined to a specific jurisdiction.

1.8 CHAPTER SCHEME:

The present Chapter, being the First Chapter, presents the introduction of the subject and the methodological aspects of the Dissertation together with a discussion on the scope, significance and limitations of the study. The Second Chapter describes the conceptual and applied aspects of particularly the direct taxes and a discussion on the direct tax reforms' objectives. The Third Chapter is devoted to the discussion on the historical perspective of the direct tax reforms and takes a review of the recommendations of several tax reform committees appointed by the government in the post-Independent period. The Fourth Chapter is devoted exclusively to the discussion on the recommendations submitted by Dr.Raja

J.Chelliah Committee, with specific emphasis on the 'Presumptive tax scheme', 'Taxation of capital gains' and 'Taxation of agricultural income'. The Fifth Chapter, being the last Chapter, firstly presents the researcher's conclusions drawn at the end of the research work and secondly, offers concrete suggestions on further reform endeavour to make the direct tax structure more dynamic and responsive in the changed economic scenario. The research work was entirely based on library research and the bibliographic sources used for the purpose have been listed in the 'Reference' section at the end of each Chapter. Hence, no separate Bibliography has been appended to the Dissertation.

REFERENCES:

This Chapter is based on the authoritative comments and contents of the following publications:

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