CHAPTER TWO

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2.1 INTRODUCTION:

The term 'direct tax' stands defined under section (2) of the Central Board of Revenue Act (LIV of 1963). Accordingly, a '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 Profit 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.

Since the Estate Duty Act of 1954, the Expenditure-tax Act of 1957 and the Super Profits Tax Act, 1963, have all been abolished, the present study concerns itself with the legislative provisions' reform of the Income-tax Act, 1961; the Wealth-tax Act, 1957, and the Gift-tax Act, 1958.

2.2 MEANING OF DIRECT AND INDIRECT TAXES:

The most wellknown distinction between the direct and indirect taxes is the one made by J.S.Mill:

> "A direct tax is demanded from the very persons who, it is intended or desired, should pay it. Indirect taxes are those taxes which are demanded from one person in one expectation and intention that he shall indemnify himself at the expense of another".

According to Mill, taxes were direct or indirect depending upon the fact whether they were actually paid by the people on whom the burden fell or not.

Taxes can be on income received or an expenditure incurred. Those taxes which are imposed on the receipts of income are called 'direct taxes', while those which are imposed on the expenditure are regarded as 'indirect taxes'. On this basis, income-tax, profit-tax and capital gains-tax' are the examples of direct taxes; while excise-duties, customs-duties and sales-tax are the examples of the indirect taxes.

According to Dalton,

> "A direct tax is really paid by the person on whom it is legally imposed, while an indirect tax is imposed on one person but paid partly or wholly by another, owing to a consequential change in the terms of some contract or bargain between them".

Therefore, income and property taxes are the direct taxes while customs and excise duties are the indirect taxes.

2.3 DIRECT AND INDIRECT TAXES : A COMPARISON:

Direct and indirect taxes may be compared from their different angles:

1. Allocation Aspects,
2. Administrative Aspects,
3. Distributional Aspects.

1. Allocation Aspects:

Economists have maintained that the allocative effects of indirect taxes are inferior to those of the direct taxes, that is, if a certain amount of money is collected from the community by way of indirect taxes (or excise duty), the burden will be greater than if the same amount were to be collected by way of a direct tax (personal income-tax). In other words, a direct tax has harmful effects on the allocation of the resources than the indirect one.

2. Administrative Aspects:

Direct and indirect taxes may be compared from the point of view of administrative costs and efficiency. From the administrative point of view, direct taxes are not levied on low income and suitable exemption limits are provided for the income-tax. In other words, from the administrative point of view, indirect taxes were considered superior to direct taxes. They are easy to collect, they are convenient and are difficult to evade.

3. Distributional Aspects:

A comparison may be made of the two types of taxes on the basis of their distributional aspects. It used to be held that direct taxes were pre-eminently suited to bring about a reduction in the inequality of income in the capitalist system. Hence, direct taxes were considered very progressive. Indirect taxes fall on incomes and, therefore, they have been regarded as generally regressive.

2.4 A SOUND TAX SYSTEM:

A sound tax system will depend upon the nature of public expenditure. A sound tax system.. may be the one which not only brings in adequate revenue for all the necessary functions of economic stabilization. Adam Smith gave the following principles/canons which should be incorporated in any sound system of taxation:

1. Ability,
2. Certainty,
3. Convenience,
4. Economy,
5. Simplicity,
6. Productivity.

A brief description of each of these follows:

1. Ability: All citizens should contribute towards the expenses of the government "as nearly as possible in proportion to their respective abilities".

2. Certainty: The amount to be paid, the time and the method of payment should all be clear and certain for the taxpayer to adjust his income and expenditure. The state should know how much revenue it could expect and when it could get it - to prevent exploitation.

3. Convenience: It should most likely to be convenient for the contributor to pay it.

4. Simplicity: There should be simplicity in the tax structure and the tax system should be easily comprehensible to the common man.

5. Productivity: It should produce adequate revenue to meet the public expenditure.

Aims of Sound Taxation:

A sound tax system should be based on the principle of progression, i.e. the rate of tax should rise with the rise in incomes and the tax burden should be increasingly borne by the richer class. Following are the four general characteristics of a sound tax system:

1. Equality in the distribution of tax burden,
2. Productivity of the tax system,
3. Recognition of the rights and problems of taxpayer,
4. Adaptability of the tax structure to meet the changing needs of the economy.

A brief description of each of these characteristics follows:

1. Equality: Two aspects for the problem of equality - the rule: equal treatment to all equals. All those persons who are placed in similar circumstances should bear the same burden of taxation. The second aspect of equality in taxation - those who are better-off should pay more taxes and thus should bear a greater burden of taxation.

2. Productivity: The basic purpose of taxation is to get revenue, for both regulatory and non-revenue use. Taxes are not only meant to collect revenue but also for the redistribution of income, stabilization of economy. Tax productivity does not mean simply revenue returns. A sound tax system should ensure adequate and regular revenue to meet the requirements of the economy. The revenue yield of any tax will depend upon a variety of factors, such as the tax-base, the rate of tax, the various exemptions, the efficiency of the tax administration and the psychology of the particular taxpayers.

3. Rights of Taxpayers: A sound tax system will have to safeguard the interests of the taxpayers. The present level of taxation as well as its further prospects necessitate that the interests and rights of taxpayers should be given recognition. Apart from the interest rights of the taxpayers, who support governmental functions, high taxpayer morale is essential for the effective administration of tax laws. An intelligent concern with the taxpayers' problems will require

the public authorities to:

(a) make efforts to broaden their understanding of particular tax measures;

(b) reduce to the minimum the inconvenience and interference associated with tax payment and collection; and

(c) provide for prompt and fair treatment of their complaints.

As regards the first aspect, it is essential that the tax laws are simple and that their basic provisions and principles are easily understood by the comman man. As regards the second aspect, it may be mentioned that inconvenient time and methods of tax payments can prove to be highly irritating to the taxpayers even though they may be willing to pay the taxes. The tax system should be so devised that the sources of irritation and resentment may be reduced to the minimum. Finally, the equitable enforcement of tax obligations upon all taxpayers may lead to inconvenience and interference. The job of enforcement is highly irksome, requiring tact, courtesy, impartiality and continuous vigilance in the direction of evasions and avoidance. The taxpayer may feel aggrieved by the behaviour of the enforcement staff. The prompt and fair disposal of the complaints of taxpayers is a specialized, but significant, aspect of the general problem of maintaining the taxpayer's morale and efficient administration.

A study was conducted by K.C.Sharma under the title 'Impact of Fiscal Policy on Private Corporate Sector' and it was pointed out that the rationalization of the tax structure in general and the reduction in corporate as well as personal income-tax in particular during the last few years. A progressive tax structure may be theoretically laudable from the viewpoint of reducing disparities of income and wealth, but in actual practice, it may turn out to be counterproductive and discourage investment and productivity and lead to large-scale tax evasion and creation of black money economy. The reform in the direct tax structure initiated in the 1985-86 budget by reducing the rate of income-tax on corporate and professional income was considered reasonable, was designed to 'promote better tax compliance and higher revenue realization'. The stability in taxation was considered as an important feature of rationalization of the structure. It was felt that 'too frequent changes in the tax structure are a source of uncertainty which discourages tax compliance, creates difficulties for effective tax administration and takes its toll of economic growth'. To discourage tax evasion by removing weaknesses in the law by incorporating certain provisions in the direct tax laws and enactments of the Direct Tax Laws Act, 1987. It was also noted that the tax reforms had started yielding dividends and the tax revenues had shown considerable buoyancy. He, however, observes that the tax reforms have not been initiated in order to have a rationalist, simplified and coherent tax structure, even in the area of corporate sector.

2.5 SCOPE AND DIRECTION OF REFORM:

Direct taxes deal mainly with the personal income-tax, that is, the income-tax on non-corporate entities and the tax on wealth and also deal with the corporate taxes.

For restructuring the direct taxes, a structure is fairly simple. The rate structure, while imparting progressivity to the tax system, should not give substantial inducement to the generation of black income and wealth.

In designing the overall scheme of direct taxes, one major aim kept in view that in a country where only a small proportion of the population pays direct taxes, the progressivity of the direct tax structure also is important, because it affects the distribution of the tax burden within the income-tax paying groups.

The income-tax can become a very inequitous method of raising revenue if the tax provisions result in unfair and unequal treatment of different individuals in similar economic circumstances or if the law is not applied to all sections of the taxpayers with equal effectiveness. A wellknown fact is that the existing income-tax structure is riddled with anomalies and tax shelters make the system unfair as between equals.

Despite its shortcomings and the problem of administering it, taxation of income is practised in most countries of the world, primarily because income constitutes the best single index of economic power. If taxation is to be based on the principle of 'ability-to-pay, it is difficult to find a superior alternative; however, if it is to provide a reliable index of taxable capacity, 'income' must include all ingredients of economic power acquired by a taxpayer over a given accounting period (usually a year) whether such power is actually exercised through consumption and shared by saving as reflected in the net accretion to one's wealth over the period.

The erosion of tax base that has taken place as a result and the consequent ill-effects on equity and efficiency are well known and have provided the main motivation for tax reform throughout the world towards a wider base of the income-tax with moderate rates. Highly progressive rates have little significance when there are so many relief provisions and loopholes and the evasion is widespread. Both vertical as well as horizontal equity require that the income-tax be levied on a comprehensive income base, comprising all major ingredients of one's taxable capacity, having regard, of course, to the considerations of administrative and compliance problems. These are the directions in which the proposals put forward in the Chelliah Committee Report are designed to reform the present income-tax system.

Measures for widening the income-tax base and the rationalization of the structure are considered under the following broad heads:

a. restructuring the tax rate schedule;

b. rationalizing the definition of the tax unit;

c. elimination/rationalization of exemptions and deductions;

d. widening the scope of taxation of perquisites and fringe benefits;

e. redesigning the scheme of taxation of capital gains;

f. reviewing the expense-deduction rules.

Equity in income taxation requires that all incomes in whatever form received should be brought into the tax base after allowing for legitimate costs of earning. It is, therefore, necessary to ensure that all those having taxable income are brought into the tax-fold.

Revenues of the Central Government:

The Union Government has has a revenue budget, that is to say, the estimates of receipts and disbursements on revenue account and a capital budget, which relates to receipts and disbursements on capital account. The estimates of receipts on revenue account have been grouped under two broad headings: tax-revenue and non-tax revenue.

The tax-revenue has been divided into:

1. taxes on income;
2. taxes on property and capital transactions; and
3. taxes on commodities and services;

and the non-tax revenue has been divided into:

1. fiscal and other services,
2. interest deposits, and
3. dividends and profits.

Table 2.1

Revenue of central government in the revenue account

	1950-51 (Actual)	1970-71 (Actual)	1980-81 (Actual)	1992-93 (Budget)
Tax revenue (net of state's share)	357	2450	9390	56460
Non-tax revenue	40	890	3440	19230
Total revenue	406	3344	12830	75690

The above Table reveals that the total revenue of the central government has been rising fast - more taxes, higher rates of taxes and also due to the inflation. The total revenue of the central government was a little more than Rs.400 crores in 1950-51 which had risen to Rs.12,830 crores in 1980-81, while in the 1992-93 budget, it would be around Rs.75,690 crores. Even between the period 1981 and 1993, the total tax revenue has gone up by 100%.

Relatively, the tax revenue was 88% of the total revenue in 1950-51 and it declined to 73% in the year 1970-71 and is around 75% of the total revenue now. Proportionately, the yield from the non-tax revenue gradually rose from 12% to 125% during the same period.

2.6 DIRECT TAX REFORMS : OBJECTIVES:

It is very crucial to set out clearly the objectives that the government wants to realize from the proposed direct tax reforms before they are launched. The identification of these objectives will be useful in drawing the format of the reforms slated for inclusion in the existing tax system to obtain the desired results. Such objectives should precisely include the following:

1. <u>Widening of tax-base/tax-net:</u>

In a country with a population of about 900 million, the number of tax payers are hardly little over 7 million not even one percent of the total population. This is mainly because of keeping nearly 70 percent of population who derive their income from agriculture out of the tax net. Even among the remaining 30 percent, there is a large section of the population somehow managing to be out of the tax-net despite higher incomes. Further, inspite of higher rate of taxation in India, the tax revenue does not exhibit sufficient buoyancy with the increase in the national product and income, whereas, most of the developed countries collect 25 to 30 percent of the GNP through taxation, Bhootalingam Committee has rightly suggested that "ideally tax system should be built in such a way that the growth in the national income will be automatically reflected in the revenue of the state".

In this connection, a perusal of Table 2.2 (next page)

Table 2.2

Trends in structure of Central Government Revenue

	Rs. in crores				% share in Total Revenue		
	1970-71	1980-81	1991-92	1992-93	1970-71	1980-81	1992-93
1. Corporation tax	371	1311	7300	8125	6.5	5.4	6.1
2. Income tax	473	1506	6788	7870	8.3	6.2	5.9
3. Wealth tax	15	68	255	300	0.3	0.3	0.2
4. Estate duty	8	16	3	3	0.1	0.1	-
5. Others	10	107	654	855	0.2	0.4	0.6
(A) Direct Taxes (1 to 5)	877	3008	15000	17153	15.5	12.4	12.9
6. Customs	524	3409	22895	25212	9.2	14.1	19.0
7. Union Excise Duties	1759	6500	27696	32211	31.0	26.9	24.3
8 Others	47	263	1709	1947	0.8	1.1	1.5
(B) Indirect Taxes (6 to 8)	2330	10172	52300	59370	41.0	42.1	44.8
(C) Gross Tax Revenue (A+B)	3207	13180	67300	76523	56.5	54.5	57.8
(D) Transfer of States share	755	3792	17199	19992	13.3	15.7	15.1
(E) Net Tax Revenue (C-D)	2452	9388	50101	56531	43.2	38.8	42.7
9. Fiscal Services	26	143	787	820	0.5	0.6	0.6
10. Interest Receipts	589	1795	11297	13464	10.4	7.4	10.2
11. Dividend and profits	121	292	1049	2622	21	1.2	2.0
12. Other receipts	154	1211	6975	6287	2.7	5.0	4.7
(F) Revenue Account Receipts (1 to 12)	3342	12829	70209	79724	58.9	53.1	60.2
13. Capital account	2046	8771	43253	47394	36.1	36.3	35.7
14. Budgetary Deficit Financing	285	2577	7032	5389	5.0	10.7	4.1
TOTAL RECEIPTS:	5673	24177	120494	132507	100.00	100.00	100.00

Source: Basic statistics relating to the Indian Economy, Centre for Monitoring Indian Economy, Vol.1, August 1992.

suggests that there is an immediate need to widen the tax base so as to augment the revenue position of the central government. It may be seen from the Table that there has been a considerable decline in the share of net tax revenue in general and direct taxes in particular. The share of direct taxes in the centre's revenue, which was 15.5 percent in 1970-71, declined to 12.4 percent by 1980-81, and it is expected to be 12.9 percent during 1992-93. Though there has been slight increase in the share of indirect taxes in total revenue, on the whole, after transfer of state's share, the share of net tax revenue in the total revenue of the central government has shown a decline. Therefore, a time has now come to widen the tax base/tax net to improve the share of tax revenues in the overall revenue of the government.

2. Restoration of Equity and Balance in Fiscal System:

In the improvement of revenues from taxes, the accent should necessarily be on direct taxes, since, indirect taxes are already considered to be on the higher side. The revenue from direct taxes, as a percentage of total tax revenues has shown a steady decline over the time and as a proportion of GNP, it remained stagnant thus immpairing the equity and balance in the fiscal system. This trend may clearly be noted from the figures furnished in Table 2.3 (on the next page).

Table 2 3

Direct, Indirect and Total Taxes
(Centre, States and Local Bodies)

YEAR	Tax revenue (Rs crores)			% share in total tax revenue		Tax revenue as % of GNP		
	Direct	Indirect	Total	Direct	Indirect	Direct	Indirect	Total
1950-51	231	428	659	35	65	2.5	4.6	7.1
1960-61	420	1040	1460	29	71	2.6	6.4	9.1
1970-71	1091	3864	4955	22	78	2.5	9.0	11.6
1980-81	3575	16746	20321	18	82	2.6	12.3	14.9
1981-82	4461	20089	24550	18	82	2.8	12.6	15.4
1982-83	4835	22985	27820	17	83	2.7	12.9	15.7
[illegible]	5355	26471	31826	17	83	2.6	12.8	15.4
1984-85	5806	30640	36446	16	84	2.5	13.3	15.8
1985-86	6574	36987	43561	15	85	2.5	14.2	16.7
1986-87	7328	42714	50042	15	85	2.5	14.7	17.2
1987-88	8001	49847	57848	14	86	2.4	15.1	17.5
1988-89	10396	57430	67826	15	85	2.7	14.7	17.3
1989-90	11351	66875	78226	14	86	2.5	15.0	17.5
1990-91	14378	75925	90303	14	86	2 7	14.5	17.2

Source: Same as Table 2.2.

It may be seen from this Table that the share of the revenue from direct taxes in the total tax revenue has steadily declined over a period of time and it accounts for 14 percent of total tax revenue today as against 86 percent of indirect taxes. Further, while the proportion of indirect taxes in GNP has by and large shown a steady increase over the time, the proportion of direct taxes in GNP has almost remained stagnant during the same period. This trend has to be reversed, if the equity and balance is to be restored in our fiscal system. In the past, the Union finance ministers were known to be wary of direct taxes. While acknowledging this fact, the present Union finance minister, Dr.Manmohan Singh, has boldly made a conscious effort in the 1991-92 budget to mobilize over 80 percent of the revenue through direct taxes. In the light of this, it is very much essential to see that one of the objectives of the indirect tax reforms is to restore equilibrium in the fiscal system.

3. Control of Tax Evasion and Black Money:

An important malady of our direct tax system that needs to be tackled without losing time is the control of tax evasion and black money which undermine equality concept of taxation. Though it is very difficult to have an estimate of the black money in circulation, according to the 'guess estimate' of the Report of the Direct Taxes Enquiry Committee, "not only is black money running parallel economy in this country, but it is growing faster than national income".

Based on the Report of the National Institute of Public F Finance and Policy (NIPFP) on black money published in 1985, the black money in circulation, at an estimate, is to be around Rs.50,000 crores per annum. The ill-effects of tax evasion and black money are too well known to be well explained.

4. Improvement in Elasticity of Tax Revenues:

One of the important canons of tax system in India is the canon of income-elasticity of tax revenue. As inccmes rise, the share of tax revenue in total revenue must be also rising. At present, all governmental units in India together take in tax revenue only around 17 percent of the Gross National Product, while it is around 25-30 percent in develcped countries. Thus, there is also an immediate need for improvement in elasticity of tax revenues and increases in its share in the central revenues.

The above are only some of the objectives that tax reform should aim at, so as to make the tax policy more appropriate and conducive to the needs of development at every stage of economic development and hence has to be integrated with the development policy of the country. But the past experience shows that the government, due to lack of appreciation of the development problem, has failed to integrate tax policy with the development policy of the country.

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