ECONOMIC GROWTH REQUIRES REFORM OF TAX STRUCTURE

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> "People must come to accept private enterprise not as a necessary evil, but as an affirmative good."
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> —Eugene Black
> President, World Bank

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THE tax policy of any country is dictated not only by its economic needs but also by the political conditions prevailing within it. There are a wide variety of objectives which tax policy could pursue and there is often a basic conflict between the different objectives. Tax policy must, therefore, constitute a compromise between the various diverse objectives. The nature of that compromise must change with economic growth and progress. Taxation is only one of the economic weapons in the armoury of modern governments, and it must be viewed in the context of various factors operating in the total economic picture.

One of the most universally accepted economic and political objectives of the Government of India's policy is the promotion of economic development at the fastest possible rate. Thus the Third Plan aims to increase the national income at the rate of 6 per cent a year. The last two plans have also been dominated by the main objective of promoting the growth in the national income or economic prosperity. Economic development is a function of savings and investment. In the present context where the private sector continues to play an important role, economic development is largely determined by the entrepreneureal or risk-bearing activity of the business and industrial classes who share the responsibility of starting new enterprises. The main objective of tax policy should, therefore, be to

provide conditions which will stimulate the growth of savings at the maximum possible rate; and the investment of savings in a way which will promote maximum economic development and the promotion of entrepreneureal activity necessary to ensure the proper investment of savings in sound new enterprises. I suggest that tax policy should be predominantly incentive-oriented.

Taxation is only one of the factors influencing savings and investment. Other economic and political factors—like the Government's industrial policy, the availability of vast markets to absorb the products of industries and a wide variety of different investment opportunities—influence the growth of savings and investment in an economy. Nevertheless, taxation is one of the most important factors influencing savings and investment, especially in so far as the increases in taxation reduce substantially the capacity of individuals or companies to increase their rate of savings.

The incentives to savings and investment are not only determined by real factors, but are largely influenced by psychological ,ones. While the present level of taxation has an important bearing on the incentives to savings and investment, the expectations about the future course of tax policy often exert an extremely powerful influence on the incentives of the private sector to save and invest. Stability in taxation acts as a powerful factor in promoting confidence, provides a spur to the incentives to save and invest and can, therefore, be of great importance in economic development of a country. For example, it may be mentioned that the introduction of no less than four successive Budgets at short intervals between September 1956 and May 1957 and the imposition of a number of new and, as I claim later, unsound direct and indirect taxes created a state of chronic instability in the tax structure at that time, destroyed the confidence of the investing public and raised such apprehensions in their minds about the future course of taxation that an extremely severe blow was dealt to the incentives to save and invest at that time. On the

other hand, although taxation has continued at a high level since then, the relative stability of tax policy after the appointment of Mr. Morarji Desai as the Central Finance Minister has promoted optimism about the future among the investing classes. It has also been responsible for the buoyancy in the capital market since 1959 and has, to some extent, revived the incentives to greater savings and investment. It is, therefore, essential that tax policy in the coming years should aim at stability, follow the goal of promoting a continuous rise in the growth of savings and investment and provide an economical tool to spur the development of the country.

It may be relevant to examine the record of savings and investment of the past five years. During the second Plan, India did not witness a steady increase in the rate of savings and investment. The Reserve Bank estimated that the rate of savings stood at 8.6 per cent of the national income in 1956-57. The rate of savings actually fell during the year 1957-58 to 7 per cent of the national income. The Third Plan states that savings today stand around 8.5 per cent of the national income. The regrettable fact, therefore, emerges that during the years of the Second Plan when the country should have been developing and the the rate of savings should have progressively grown, there has been a situation in which savings have not risen, the rate having been stagnant around 8 per cent of the national income. The Third Plan is based on a rate of savings of 11.5 per cent of the national income. To achieve such a rate of savings, it will be necessary to reappraise the economic policy of the Government. I suggest that tax policy be remodelled to promote the increased rate of savings which is essential if the economy is to progress and the Third Plan to succeed.

In a mixed economy like India's, economic development depends jointly upon both private savings and public savings. It has ben emphasised that tax policy should provide the strongest incentives for the growth of private savings. It may be argued that this may not be necessary

if there is a substantial growth of public savings. But such an argument would be completely erroneos in the present context because recent studies have shown that public savings in the economy, far from rising, are actually declining. The National Council of Applied Economic Research in its *Savings in India,* published in early **1961,** points out that net savings by the Government sector declined from Rs. **208.9** crores in **1951-52** to Rs. **141.8** crores in **1957-58.** Yet, in the same period, the net investment in the Government sector increased from Rs. **221.1** crores in **1951-52** to Rs. **794.8** crores in **1957-58.** It is quite clear that increasing investment in the Public Sector has had *to* be financed by the Government by attracting to it a substantial volume of private savings and external assistance. Hence, India is today in a situation where the growth of private savings is of paramount importance not only to finance investments for the Private Sector but also to provide the resources for investment in the Public Sector. The need in the coming years must be to explore every conceivable avenue to promote the growth of private savings, and tax policy can be one of the most potent tools for achieving this end.

The next objective of tax policy should be to provide revenues required by the Government to finance its current expenditure and provide resources for investment in the Public Sector. Tax policy during the past five years has been substantially dominated by the need to raise ever-increasing revenues at the cost of the various other objectives of tax policy. There has been a continuous pressure during the past five years to raise ever-increasing amounts through taxation to finance the reckless expansion in the bureaucratic machinery. The expenditure on civil administration, *i.e.,* non-developmental and non-productive expenditure, rose from Rs. **94.08** crores in **1955-56** to **Rs. 233.35** crores in **1959-60.** It further rose to Rs. **260.05** crores in **1960-61,** representing an almost three-fold increase in this expenditure. While some increase in the expenditure is inevitable in a developing country, it is impossible to

justify a rise to almost three times the level prevailing six years ago. Indeed, an extremely high proportion of the tax revenues raised through additional taxation in the Second Plan has been eaten up by the rise in non-developmental expenditure of the Government and has, therefore, made no contribution whatsoever to the economic progress of the country. This tendency needs to be checked in the Third Plan if the rate of investment in the economy is to be increased. It must be pointed out that a substantial portion of tax revenues frittered away by the Government in non-developmental expenditure could have found its way into proper investment channels if additional taxation had not been levied. An increase in non-developmental expenditure at the cost of productive investment represent an uncondonable waste and a factor retarding India's economic development.

Moreover, in the search for revenues during the past five years, the implications of collecting the new taxes imposed ahd especially the cost of their collection have often been ignored. There has been a tendency in the past five years to impose a large number of different taxes each of which has yielded small amounts in revenue but which, I suspect, has involved costs of collection and administration far in excess of the normal proportion which collection costs of good tax measures should bear to revenue. In the search for revenue, it is essential that not only the gross revenue should be considered but, even more important, **net** revenues should be clearly estimated, *i.e.,* gross revenues minus costs of collection should be clearly estimated, so as to get a proper picture of the efficiency of various tax measures. For the future, it is essential that India should give up this habit of imposing a tremendous variety of taxes and concentrate on a broad tax policy containing a minimum of taxes and tax enactments and yielding the maximum of net revenues to the exchequer.

The third objective of tax policy] in India is the reduction of inequalities in wealth and income and economic power. This objective flows from the philosophy of the

Government. Over a period of time, a reduction in inequalities and especially the creation of conditions under which vast masses of people have equal opportunities for progress can accelerate economic development. This could result from the creation of a society in which the masses are educated, alert, dynamic and able to create and seize economic opportunities for progress. On the other hand, an excessive emphasis on the objective of reduction in incquilities of wealth and income and politicians' temptation to soak the rich by levying extremely high tax burdens on the upper classes could retard economic progress in the immediate or near future by depressing the level of savings and entrepreneureal activity. In an under-developed country like India, voluntary personal savings are only possible by the middle and upper income classes who can have a small surplus after meeting their necessary consumption expenditure. The vast mass of people live at economic levels which are so low that any increase in their income tends to be immediately spent on consumption expenditure, so voluntary savings are totally non-existent.

Under the circumstances, levying high direct taxes on the richer classes merely in order to achieve the goal of reducing inequalities of wealth and income must result in a fall in the level of private savings and retard economic development. Indeed, as has been pointed out, the growth of savings during the last three years has been most disappointing and, to a large extent, the cause of this can be traced to the fact that additional direct taxation during the Second Plan has almost totally crippled the capacity of individuals in the upper income brackets to save. The Third Plan stresses the objective of reducing inequalities of wealth and income and securing a more even distribution of economic power, but it recognises that the objective must be pursued in the context of the broader national goals for rapid economic development.

Another objective of tax policy in India, as in all under-developed countries, should be to attract foreign investment and foreign technicians and personnel. It is

now recognised that a flow of foreign investment into India will enable her to develop and industrialise at a rate which will be faster than the rate at which the country could hope to progress by depending only on internal resources and savings. The Government has, therefore, been keen in recent years to attract foreign capital into the country. This is a policy which will have to be pursued in the coming years through sheer enlightened economic necessity. Similarly, India is in need of many technological and even managerial skills which have to be secured from the rest of the world by attracting foreign technologists and personnel into the country. Foreign industrialists, companies and governments have often pointed to the high level of Indian taxation as well as its administrative complexity as one of the important obstacles preventing a larger flow of foreign capital and personnel into the country. It has been pointed out that India's tax structure imposes a burden both on companies and on personnel which is much higher than that prevailing in almost all the under-developed countries and even in many of the more advanced countries. During the Third Plan, the country hopes to attract a substantial volume of foreign investment and know-how. It is essential that the tax policy be reoriented in part to attract foreign personnel and investment at a substantially increased rate during the coming years.

Having reviewed the broad objectives of tax policy, I want to examine the Government's record in taxation during the second plan in relation to the objectives already outlined. I will first deal with the direct taxation of individuals. At the beginning of the second plan, individuals paid only two direct taxes, namely, income tax and estate duty. The former was levied on personal incomes at progressive rates. The burden of this tax has been raised steadily by successive Finance Acts over the past decade. Although slight reductions in the rates of income tax were made in 1957 when various other direct taxes were introduced, the burden of income tax on personal incomes in India remains highly progressive. The National Council of

Applied Economic Research, in its study entitled Taxation and Private Investment published in March 1961, stated: "The international comparison of tax rates indicates that the Indian income tax is highly progressive—one of the most progressive systems in the world and that the tax burden on the upper income levels in the range considered by us (namely, on incomes above Rs. 13,000 a year) is one of the highest".

In 1957, wealth tax was imposed on the net wealth of individuals in excess of Rs. 2 lakhs at the rates which have since been raised to the present level of between 1 per cent and 2 per cent of the total net wealth and is payable annually. In the same year, the Central Finance Minister introduced the novel expenditure tax under which personal expenditure of individuals in excess of Rs. 30,000 is taxed at sharply progressive rates ranging from 10 percent to 100 percent. A tax on capital gains made by individuals at progressive rates ranging up to 30 per cent of the value of capital gains was introduced by the end of 1966. A tax on gifts made by individuals at the rates similar to those of estate duty was introduced in 1958 and finally its burden on individuals was enhanced under the Estate Duty Amendment Act of 1958. As a result of the fiscal experiments during the Second Plan, there are no less than six different direct taxes levied on individuals in India today.

The impact of the structure of direct personal taxation on the incentives to save and invest has been a strictly negative one. In public lectures and various papers written in 1957-58, I pointed out that the imposition of wealth tax in addition to income tax levied at high rates has resulted in a direct tax burden which, onaccount of these two taxes only, places a ceiling of between Rs. 25,000 and Rs. 30,000 as a maximum amount which an individual is able to retain out of his income after paying income tax and wealth tax (assuming a 6 percent return on investment). These maxima are reached around a total slab of wealth of between Rs. 10 and Rs. 15 lakhs. Beyond these slabs, every increase in

income and wealth is accompanied by a drastic reduction in the total amounts left in the hands of the assessee after Paying only these two taxes. Actually an incredible point is reached at which the entire income of an individual is confiscated by these two taxes and beyond this point, not only is the entire income confiscated annually but also a portion of the capital has to be paid in order to satisfy the tax liability on account of income tax and wealth tax.

Moreover, the various other direct taxes being imposed in addition to'income tax and wealth tax have enhanced the burden of taxation to the point at which the capacity of the richer classes to save has been completely crippled and their incentive to save and invest extinguished. This is bound to have serious adverse long-run repercussions on the growth of entrepreneurship and risk-bearing by the business and industrial classes in the country. Indeed, evidence is available that as a result of the new tax structure, personal savings have received a serious setback. The recent survey of the National Council of Applied Economic Research, the findings of which are given in its book entitled Taxation and *Private* Investment, indicates that as a result of the new tax structure, entrepreneurs and the richer classes had been unable to save during the last three years. Indeed, the Council's survey stresses the undesirability of the present set-up under which more than 100 per cent of the annual income of these classes is often taken away by income tax and wealth tax. Thus the Council has concluded that "the direct tax structure of India cannot be said to be deliberately geared to the promotion of savings, especially personal savings."

The Official figures published by the Reserve Bank also seem to indicate that the total volume of personal savings in the Indian economy was not rising during the Second Plan and indeed was falling. The Reserve Bank estimates that the total volume of personal savings in India has fallen from between Rs. 722.70 crores in 1955-56 and Rs. 827.58 crores in 1956-57 to only Rs. 669.97 crores in 1957-68. There is a crying need for a reappraisal of direct personal

taxation due to the necessity of promoting personal savings, especially when it is realised that these constitute more than 80 per cent of the total savings in the country.

From the revenue angle, the new taxes have not yielded the vast sums of money of which hopes were raised by the British economist, Mr. Nicholas Kaldor, who recommended the introduction of the various taxes. Nor have the hopes of the then Central Finance Minister, Mr. T. T. Krishnamachari, who introduced these taxes, been fulfilled. Income tax still continues to yield an overwhelming proportion of the total revenue from direct personal taxation, its yield having fluctuated during the Second Plan period between Rs. 80 and Rs. 100 crores a year. The yield from wealth tax on individuals has been estimated at Rs. 4.50 crores for 1957-58, at Rs. 5 crores for 1958-59, at Rs. 6.50 crores for 1959-60, at Rs. 7.50 crores for 1960-61 and at Rs. 7 crores for 1961-62. Expenditure tax, which was introduced in this country for the first time in the history of the world and much against the advice of veteran economists and tax experts, has failed completely to yield any sizeable revenue. The tax was originally estimated to yield Rs. 3 crores in its first year of operation, 1958-59. But the revised estimates for that year. put the yield at only Rs. 1 crore, and it has now been revealed that the actual yield of the tax was only Rs. 65 lakhs, of which Rs. 56 lakhs came from the princes so that' the total collection from the ordinary citizens came to only Rs. 9 lakhs. Over the year 1959-60, the revised estimates put the yield from the tax at Rs. 80 lakhs and for 1960-61 it was Rs. 90 lakhs. For 1961-62, the tax is estimated to yield only Rs. 80 lakhs.

Capital gains tax has also failed to produce any sizeable revenues, having yielded only Rs. 39 lakhs in 1958-59 for which figures are now available. Gifts tax is estimated to have yielded slightly around Rs. 80 lakhs a year, and the yield from estate duty during the Second Plan period has been between Rs. 1.80 crores and Rs. 3 crores a year. The following conclusion is, therefore, inescapable: the various

new direct taxes have failed to provide sizeable revenue to the exchequer because they were unsoundly conceived and also because the limit of direct taxation had already been passed in this country so that the new taxes did not find any great surpluses left to confiscate from private individuals.

It can be said without hesitation that the various new direct taxes on individuals were introduced in order to play up the political trend of trying to soak the richer classes mercilessly so 'as to increase the popularity of the Government. The new structure of direct personal taxation imposed a total burden of taxes which is estimated in excess of that prevailing in other countries of the world so that it has made it extremely difficult to attract foreign personnel into this country. Indeed, as a recognition of India's excessively heavy rates of tax, the Government has had to give a concession under which salaries of foreign technicians are totally exempt from income tax for a period of three years. But this exemption only applies to certain specific categories of foreign personnel. The general tax structure still continues to act as a very substantial deterrent to the flow of human skills from abroad into the country. Thus Mr. S. P. Chambers, chairman of Imperial Chemical Industries, during a visit to India pointed to the excessively heavy burden of direct personal taxation as a strong deterrent to the flow of personnel into the country. He went to the extent of saying that even in Russia human efforts are better paid, rewarded and appreciated than in this country.

At the beginning of the Second Plan, companies had to pay income tax and corporation tax on the profits made by them. By 1957, the rate of income tax was fixed at **31.5** per cent and that of corporation tax at 20 per cent of taxable profits of companies. However, up to 1959, income tax paid by companies on their profits was refundable to their shareholders who received tax credit for it when they were paid their dividends. This was known as the system of grossing of dividends. The procedure for

the grossing of dividends caused serious administrative complications. This led to the introduction of the new scheme of company taxation in **1959** under which companies pay the non-refundable income tax of **20** percent and the corporation tax of **25** per cent, giving a total non-refundable tax of **45** per cent of their taxable profits. Besides these taxes, a number of minor taxes were imposed on companies during the Second Plan period. In **1956, an** excess dividends tax was levied under which the dividends paid in excess of **6** per cent of the paid-up capital were taxed at progressive rates which ranged up to **30** per cent. In the same year, a tax on bonus issue, *i.e.,* bonus share issue by way of the capitalisation of reserves, was introduced, ostensibly for the purpose of checking an evasion of the excess dividends tax through the capitalisation of past reserves. In **1956,** a capital gains tax was introduced under which companies were made liable to pay tax at the rate of **30** per cent on capital gains made by them. In **1957,** a wealth tax of ½ per cent of the net wealth in excess of Rs. **5** lakhs was levied on companies. There was no justification whatever for these levies. Indeed, as a result of widespread criticism, both excess dividends tax and wealth tax were abolished when the new scheme of company taxation was introduced in **1959.** Unfortunately, the tax levied on the capitalisation of past reserves through the issue of bonus shares still continues to be in the Statute Book at the reduced rate of **124** per cent, although its introduction was originally justified as being necessary to prevent the evasion of excess dividends tax which has now been abolished. There is no justification whatever for the bonus tax because it represents a capital levy on past accumulated profits which have already borne tax once, so its abolition has been overdue.

Thus, the picture of corporate taxation in India during the Second Plan period was one of continuous experiments with different new taxes levied on companies which were unsound, so they have had to be removed. Moreover, the total burden of tax on the profits of companies has steadily

risen in the past five years and even the attempt at simplifying the administration of corporate taxation by abolishing the grossing of dividends was accompanied by an adjustment in the rates of tax which further enhanced the total burden of taxation on the corporate sector.

The main source of funds for the expansion of the corporate sector in India, as in most parts of the world, is through earnings retained in the business which constitute corporate savings. Indeed, in a country like India where capital is scarce and the new issue market highly volatile, it is extremely difficult for most companies to raise moneys through share capital and borrowings or through other sources, and retained earnings provide most of the funds for expansion. While the amount which companies can retain or plough back into their business for expansion is influenced by the level of their gross profits, it is also equally influenced by the rate of corporate taxation. A substantial increase in the latter automatically reduces the net profits which companies can plough back for the expansion of their business.

Official statistics show that although the gross profits of companies in India fell from **1952** up to **1957,** the burden of taxation as a percentage of profits rose continuously during these years. It can be definitely concluded that the rise in the total burden of company taxation, which has occurred during the Second Plan, has acted as an important factor for a reduction in the volume of corporate savings in the country. The National Council of Applied Economic Research has estimated that total corporate savings, excluding those of financial corporations, fell from Rs. **41.73** crores in **1955-56** to only Rs. **12.06** crores in **1957-58.** The Reserve Bank of India's latest figures, compiled for the whole corporate sector, show that corporate savings fell from Rs. **72** crores in **1955-56** to only Rs. **26.50** crores in **1957-58.** While the fall in gross profits of companies during these years may be partially responsible for the decline in retained earnings, it cannot be denied that the substantial rise in the tax burden as a percentage of

gross profits of companies during the Second Plan period greatly reduced the capacity of corporations to expand their retained earnings.

Certain provisions of the structure of company taxation today strongly retard the growth of small companies. Under the provisions of Section 23A of the old Indian Income Tax Act, which have been retained in the new Income Tax Act, 1961, private companies and closely controlled public companies are forced to distribute at least 60 per cent of their taxable profits in the case of industrial companies, 65 per cent in the case of non-industrial companies and 90 per cent in the case of investment companies. In the case of companies whose reserves exceed their cost of fixed assets or subscribed capital, this Section forces the distributiop of almost the entire taxable profits every year. The failure to distribute the statutory percentages of profits attracts a severe penal super tax at the rate of 37 per cent for industrial companies and 60 per cent for investment companies on the entire undistributed profits. The operation of this Section, therefore, limits the amount of profits which small companies can plough back into the business.

Moreover, since such companies find it almost impossible to raise capital from the share markets and their borrowing capacity is strictly limited, the operation of this Section not only retards the growth of small business but also puts a ceiling on the growth of small companies once they reach a certain level as prescribed by the Section. It has been repeatedly pointed out by various authorities, including the National Council of Applied Economic Research, that the provisions of Section 23A need substantial amendment if they are not to hamper the healthy development of the small and medium businesses. More than 95 per cent of private companies in India have a paid-up capital of less than Rs. 10 lakhs, and the provisions of this Section actively discriminate against the growth of such companies in favour of the larger public companies who are left to plough back as much of their profits as they feel fit. Statistical evidence is already available to show that the

growth of retained profits and also of fixed asset formation in small public companies and in private companies has substantially lagged behind the corresponding figures for the large public companies. The operation of Section 23A must have contributed to this state of affairs. The draft of the Third Plan stated that the encouragement of small and medium-sized entrepreneurs is an important goal of public policy in order to check the concentration of economic power. Yet the operation of Section 23A in its present form promotes exactly the opposite result.

The yield from the corporation tax and income tax on companies has been continuously rising. The yield from the corporation tax rose from around Rs. 37.04 crores in 1955-56 to Rs. 137.50 crores in 1960-61 and is estimated to rise to Rs. 140 crores for 1961-62. Income tax paid by companies rose from Rs. 82 crores in 1955-56 to over Rs. 110 crores in 1957-58. While companies should certainly contribute to the revenues of the Government through direct taxes levied on them, it must be recognised that continuous increases in corporate taxation, merely for revenue considerations, will have serious adverse effects on industrial and corporate growth.

Foreign companies and industrialists have often criticised not only the burden of corporate taxation but also the tendency during the past five years towards instability in company taxation due to the introduction of various new taxes and the complexities of their operation and administration. They have often urged that the adoption of a simplified structure of corporate taxation with reasonable rates of tax would act as an incentive for a larger %ow of foreign capital into India.

Throughout the Second Plan period, India has had substantial doses of additional indirect taxation every year. There have been a number of modifications in the Customs duties but these' have been of minor significance. There has been an enormous increase in the coverage and burden of excise duties which are levied on domestically produced

goods. A small tax on railway passengers was also levied from' 1957-58 onwards. Indirect taxation is justified as being necessary in order to raise revenues from the masses who are beyond the reach of direct measures. Since the masses benefit from economic development, indirect taxation is the only way in which they can be made to pay and contribute resources for the plan. It can also be looked upon as the main economic weapon for restraining the consumption and thus inducing an element of forced savings among the masses. Indeed, the burden of indirect taxes is still extremely low, compared with the direct tax burden. Statistics show that direct taxation takes away more than 25 per cent of the total assessed income of those who are subject to these taxes. Yet indirect taxation account for around 8 per cent of the *per* capita income of the country. Indirect taxation is the only feasible method of restraining the consumption expenditure of the vast masses of people in India who otherwise would certainly not voluntarily save or invest.

From the revenue angle, indirect taxes have yielded during the Second Plan period more than 65 per cent of total tax revenues of the Central Government, their yield having risen from Rs. 311.95 crores in 1955-56 to Rs. 557.98 crores in 1960-61 and estimated to rise to Rs. 670 crores in 1961-62. From the revenue angle, there has been a spectacular increase in the yield from excise duties which has risen from Rs. 145.25 crores in 1955-56 to Rs. 394.98 crores in 1960-61 and are estimated to rise to Rs. 406.24 crores in 1961-62. Revenues from Customs duties have remained semi-stagnant while the tax on railway passengers imposed in 1957-58, contributes only a small amount relative to the total yield of indirect taxes.

The levy of excise duties on a varied range of products provides the Government with a source of substantial revenue and also a potent economic weapon to control consumption and demand for the various commodities. But it must be stressed that indirect taxation is a delicate tool which, if misused, can do substantial damage to various

groups and even industries. For example, the levy of excessive excise duties on the textile industry in 1956 pushed it from a stage of considerable prosperity to one of depression, from which it took no less than three years to recover and which made it necessary to reduce the excise duties levied originally. Thus, excise duties levied on particular commodities need to be altered promptly and in a flexible manner with reference to changes in the demand and supply of those commodities,. The lack of flexibility in the Government's approach in the past to various excise duties over a period of time has often caused substantial hardships to various industries and even to consumers.

Furthermore, indirect taxation is likely to generate a strong upward pressure on costs and prices leading to inflation in the economy. The extent of inflation caused by indirect taxation varies according to the selection of the commodities which are taxed and by the nature of their demand and supply. Whereas a substantial amount of selectivity can be introduced in the use of indirect taxes in order to lessen their inflationary effects, it cannot be denied for the economy in general that they are likely to be inflationary and, therefore, involve a substantial sacrifice for the people.

The Third Plan has fixed a target of additional taxation of Rs. 1,710 crores for the five-year period, and states that the attainment of the target is vital for the successful implementation of the plan. It is recognised that the target will involve considerable effort and sacrifices for the plan, but it is justified as being essential to achieve the minimum increase in the national income of 6 per cent a year and the other goals of the plan. Out of the figure of Rs. 1,710 crores, the share of the Central Government in the additional taxation budgeted under the plan is around Rs. 1,100 crores and the State Governments are expected to raise the balance of Rs. 610 crores. This places the responsibility on the Central Government to levy an additional burden of taxation of an average of Rs. 220 crores a year during the Third Plan period.

The Third Plan states that increases will be necessary both in direct and indirect taxation, but it appears to recognise that the limit of taxable capacity has been reached, if not exceeded, in the sphere of direct taxation. The draft outline of the Third Plan stated that "as for income and corporation taxes, further increases in yields will have to be sought mainly through a tightening of tax administration, watch on expense account of companies, and other measures to check tax evasion". The Third Plan states that: "In the field of income tax, the scope for raising the rates generally is limited, although adjustments in tax rates in particular income brackets may be necessary from time to time. The objective of these adjustments must be to enlarge public resources and to spread the burden equitably as between different groups of income earners. There are at present a number of other taxes on personal incomes and wealth: wealth tax, capital gains tax, expenditure tax and estate duty. The yield from these taxes is relatively small. The object of all these taxes taken together is not only to secure larger receipts for the public exchequer but also to reduce economic inequalities. It is essential in this context that the relevant tax laws leave as few loopholes as possible for evasion or avoidance of taxes".

While I welcome measures to improve the administration of direct taxation and the prevention of tax evasion, I do not agree with this negative approach of the Third Five-Year Plan to direct taxation.

There is a definite need to reappraise the structure of direct taxation in the coming years. Even a socialist Government like that of India has been forced to recognise that there is negligible scope for further direct taxation. I would like to suggest that the burden of direct taxation on individuals should be reappraised in the light of the country's urgent need to increase voluntary personal savings. The rates of personal income tax and wealth tax should be readjusted so that no individual has to pay 100 per cent or more of his income by way of these taxes. Indeed, the rates should be suitably reduced so as to put a ceiling of

around 80 per cent of the annual income as the maximum amount which would be taken away by these two taxes. In order to provide a larger flow of personal savings available for investment in new industrial enterprises which entail a substantial degree of risk, the Government should consider adopting the practice of some countries whereby a certain percentage of income of individuals, say, around 5 per cent, could be exempted totally from income tax provided it is used in the particular assessment year for acquiring shares in new industrial companies declared as necessary and essential for the country. Such an exemption would broaden the base of the capital market and stimulate the growth of new industries.

The expenditure tax should be abolished. The Government must frankly recognise the error made in introducing this tax. It was introduced on the advice of Mr. Nicholas Kaldor who believed that the richer classes in the country were not only spending their entire income annually but were consuming large portions of their capital in ostentatious living. At that time, there was no evidence for this assumption. Indeed as I had pointed out in certain public lectures and papers in 1957-58, the richer classes in India, far from being spendthrifts, are probably "the most miserly in the world". I had at that time predicted that the expenditure tax would not yield sizeable revenues. Now it has been found that this prediction has proved true and that in the first year of its operation, the tax has only yielded Rs. 9 lakhs from the ordinary citizens, excluding the former princes. Moreover, all hopes of the tax yielding any sizeable revenue have been abandoned and at best the Central Finance Minister expects only a token contribution from it. Even to collect the token sum of revenue from this tax involves the Government in an enormous administrative task. In the first year of the operation of the tax, 7,774 assessment cases were filed for disposal with the authorities, and yielded the *magnificent* sums of Rs. 56 lakhs from the native State princes and Rs. 9 lakhs from ordinary citizens! Surely, there are better and cheaper ways of taxing the for-

mer princes than the expenditure tax. The tax has failed to produce any sizeable revenue in its first few years of operation and worse still, it is now admitted that its revenue potential in the coming years is almost non-existent. The cost of collection incurred by the Government on the tax probably exceeds the revenue gathered from it from ordinary citizens. This is, therefore, a thoroughly worthless tax which yields neligible revenue, which causes enormous harassment to assessees. Besides, it was originally levied on the basis of unsound academic theories and, therefore, must be abolished.

The Third Plan has a negative approach to company taxation. It is recognised that the scope for increasing direct taxation on corporate incomes is limited, but there are hints that some of the concessions granted to companies in relation to the direct taxes paid by them may be withdrawn. Such an approach is, to say the least, regrettable. It fails to recognise the very vital fact that during the Third Plan, the need for encouraging corporate savings for the development of industries within the country will be greater than ever before. Out of the total investment of Rs. 1,350 crores planned in the Private Sector's programmes for large-scale industries during the third plan, no less than Rs. 600 crores are expected to be financed from internal resources, *i.e.*, mainly from corporate savings. If this high level of corporate savings is to be achieved—and it is necessary to achieve it in order to fulfil the target for industrialisation of the Third Plan—a dynamic and positive approach to company taxation must be adopted during the coming years. The structure of company taxation should be simplified so as to have a flat rate of tax levied on the profits of companies at a reasonable level which is not altered and increased annually. The bonus tax should be abolished, especially as the excess dividends tax has been taken off the Statute Book, since there is no conceivable advantage for companies under the present conditions to issue bonus shares as long as the tax continues. The bonus tax yields almost nothing in revenue to the Government, lacks its

original basis or ostensible justification and continues to hamper the growth of corporate enterprises.

The provisions of Section 23A of the old Indian Income Tax Act (now incorporated in the Income Tax Act, 1961) should be adequately amended so as not to retard the growth of small companies. I suggests that it should be provided that the provisions of the Act limiting the extent of ploughing back of profits should not apply to companies having a paid-up capital of less than Rs. 10 lakhs, especially in view of the Government's declared objective of fostering the growth of small businesses in order to reduce the inequalities and concentration of economic power in the business and industrial field.

With a view to encouraging the growth of new companies in diverse fields, it is necessary to make certain adjustments in the burden of inter-corporate taxation. As a result of the new scheme of taxation the burden of tax on profits of companies whose shares are held by other companies has increased to level of almost 65 per cent of the annual profits if the taxes paid by the holding companies on their dividends received from other companies are taken into account. Most countries in the world provide substantial exemptions in order to encourage the companies to form subsidiary and associated companies to venture out into new fields of industrial activity. India should readjust the tax rates so as not to penalise the growth of inter-corporate investments.

In the proposals for additional taxation, the Third Plan states that "as for taxation of corporate incomes, a number of tax incentives and concessions are at present being given for investment. These have contributed in no small measure to high levels of private investment over the past five years. These incentives and concessions will need to be kept under continuous review so as to ensure that their benefit occurs to types of investments' that have a high priority in the plan." These statements convey a clear possibility of the Government reducing the incentives and

concessions like the development rebate and the tax holiday for the new industries which are at present given to companies. A reducton in these incentives and concessions will result in an increased burden of direct taxation on the corporate sector and as such will hamper the industrial progress of the country. Indeed, there is a definite need for increasing the incentives and concessions given to companies under the present tax laws so that they will be able to generate an increasing volume of internal resources or savings which are required for financing the industrial programmes of the Third Plan.

It is recognised in the Third Plan and in various statements made by the Central Finance Minister that the bulk of revenues in the coming years will have to be secured through indirect taxation and mainly in the form of excise duties. The Third Plan states that: "The Third Plan will involve a substantial increase in indirect taxation. The number of assessees paying direct taxes in India is very small. Although collections of direct taxes are expected to improve in the course of the Third Plan, the total of resources required cannot be raised without taxing consumption through indirect taxation over a wide range. In some cases, such taxation may be most effective at the point of final consumption; in other cases, intermediate products or raw materials may be found more suitable. Indirect taxation along these lines tends to raise the price to be paid by the domestic consumer. This is a sacrifice that has to be accepted as part of the plan. It should also not be forgotten that if taxation is insufficient, the benefit is likely to accrue to middlemen and traders in the shape of, undue profits. Some of these indirect taxes affect the poorer classes but a great many fall on those who have comparatively high incomes. There is, in other words, an element of progression even in indirect taxes. There is, however, no escape from the fact, that in a country like India where the bulk of the people are poor, resources on an adequate scale cannot be raised without calling for a measure of sacrifice from all classes of the people."

In levying excise duties, care should be taken to minimise their inflationary effects by taxing only those goods of which the open market prices have risen due to scarcities or other abnormal factors to levels which yield excessive profits to middlemen or to manufacturers so that excise duties do not sharply push up the final prices of such goods. The levy of excise duties on industrial raw materials should be avoided as far as possible because such indirect taxation results in a quick spiral of increased costs and prices, and also damages the export potential of India's industries by artificially inflating their costs above international competitive levels.

While flexibility in the approach to indirect taxation may be maintained so as to take into account the changes in circumstances during the Third Plan period, the need for maintaining a certain degree of stability in indirect taxation should not be overlooked- The chapter on price policy in the Third Plan states that "the Government has powers to control prices and make allocations for several commodities......the Government can also adjust the rates of excise duty from time to time on all excisable articles so as to alter suitably the relationship between particular prices. At present, these adjustments can be made only when the Budget is being presented. It would be desirable to examine whether in the interest of flexibility, the Government should take powers to alter excise duties suitably within defined limits in the course of the year".

It appears that in this matter, the Planning Commission has unfortunately forgotten the experience of 1956 and 1957 when successive changes in taxation every few months caused havoc in the capital markets and plunged the textile industry into one of its worst depressions on account of the ridiculously high excise duties levied on cloth. It must be recognised that changes in excise duties every few weeks would create conditions of chronic instability in the industrial structure and would retard the planned growth of industries. The Government should resist the temptation of introducing changes in the excise duties more than once

a year, that is, when the Budget is presented. Changes in excise duties at times between the annual Budgets should be considered only in times of national emergency or in extremely abnormal conditions.

Finally, in the search for revenues, it may not be out of place to look into certain areas where the revenue potential is enormous but which India has only avoided taxing in the past because of political, sentimental and historical reasons. The levy of a salt tax, the partial abolition of Prohibition or the substantial relaxation of its administration should yield hundreds of crores of rupees in revenue during the Third Plan period with the minimum of economic sacrifice and at the same time avoiding many adverse economic effects and hardships, Similarly, land revenue taxation is today in a holeless mess and continues at extremely low levels merely because the Government is unwilling to tackle the political problem of reforming this important area of property taxation. Small increases in the burden of land revenue levied under the reformed structure of land revenue taxation could yield again hundreds of crores of rupees and meet the needs of social and economic justice as well as the needs of revenue of the country. All these reforms in taxation should form part of a long range or five-year tax policy during the Third Plan period. If introduced after careful thought in the context of broader economic goals, they would help accelerate the progress of the plan and contribute handsomely to the rapid economic development and prosperity of the country.

The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise.

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"Free Enterprise was born with man and shall survive as long as man survives."

—A. D. Shroff

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