THE NEW PATTERN OF TAXATION AND ITS IMPACT ON THE INDIAN ECONOMY

by

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

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AFTER prolonged consideration I have come to the conclusion that if confidence in the economic situation of the country is to be revived, the new pattern of taxation will have to be jettisoned into the limbo of oblivion. The concept of integrated taxation finds its genesis in an academic approach. It is not based on an understanding of human nature or on the actual facts of life. Apparently there are two considerations which have influenced the adoption of this new pattern of taxation. One is the collection of the maximum revenue to help finance the Second Five-Year Plan, which once I described as a bottomless bucket, and the second is to plug all holes of possible evasion of taxation. In actual practice, these considerations do not hold good.

In the first place, let us see what this new pattern of taxation consists of. It does not merely widen but also deepens the field of taxation in that it has not only created new taxes. but has also steeply raised the rates of existing taxes. Let us now examine the various constituents of this pattern of taxation.

There is first income tax and super tax on individuals. We have had these taxes for many years in this country. But the drastic changes which are effected have brought people with only Rs. 3,000 annual income within the mischief of the Income Tax Act, whereas for many years the limit was Rs. 4,800 per annum. People in the higher brackets, from last year, are subjected to as much as 77% on their earned incomes and 84% on unearned incomes. The latter consists of things like dividends on investments and rent on houses.

On companies, there is income-tax and corporation tax. The total tax burden has been recently increased to a little over 51% against a little over 45% which was obtaining for a number of years. Then there is the recently levied capital gains tax. All capital gains over Rs. 7,500 are subject to a tax of 25%. This tax has been levied on an unscientific basis. There are other countries in the world which also levy this tax. But the main objective of this tax should be such that it encourages long-term investment. For instance in U.S.A., the Capital Gains Tax works on such a basis that the shorter the period of investment, the higher the tax; the longer the investment is held, the tax burden diminishes to a small and reasonable figure. Particularly in a country like ours and at a time like this when our objective is to bring about a rapid and large-scale development of the country, what must be encouraged among investors is to go in for long-term investment. New industries do not start returning yield immediately. It may take three, five or even more years. Therefore, if at the end of this period, the investment appreciates in value and due allowance is made for the interest Lost during the period, actually no gain is made. If at all the capital gains tax can be justified, it should be so revised that it tends to encourage long-term investment. In India, the tax is levied in an uniform manner. Whether the investment is held for 6 months, six years or sixteen years, the tax is levied at an uniform rate of 25%.

There are also taxes on excess dividend and bonus shares. The former operates when a company declares more than 6% dividend. If the dividend is between 6 and 10%, the company is subjected to a penal tax of 10%; if the dividend is between 10 and 18% then the penalty is 20%; if the dividend exceeds 18% then the penal tax is 30%. This tax works very harshly particularly in the case of companies which are called private companies and which come under a section of the Indian Income Tax Act called Section

23A. In my experience, there is no more mischievous piece of legislation in the field of taxation on the Statute Book today than Section 23A. This section is causing untold harm particularly to medium scale industries. Under our conditions, where new capital issues are so very difficult to raise, and particularly to parties who are not known to the public and whose credit has not been established with the investing public, a large number of these projects start on the basis of a promoter having an idea of setting up a new industry. In many cases the promoter himself happens to be a technical man but he has not got enough money to start the industry. He seeks the assistance of a few friends or relations, collects a certain amount of capital and starts the industry. He puts in hard work and when the industry makes good, it comes under the mischief of Section 23A, which says that 60% of profits after paying taxes must be compulsorily distributed. The effect of distributing 60% of profits on a capital which is essentially small is that the dividend rate works up to a percentage where the penal taxes on excess dividend come to operate. I am connected with a number of small and medium scale industries. I see how the operation of Section 23A drains away the resources of these companies. No scope is left for expansion. However good the project may be, the people concerned are not sufficiently known to the public and in many cases not even ta banks with the result that business which is prosperous and which provides considerable scope for expansion in future only stagnates.

There is the Wealth Tax on individuals and companies. If you are fortunate enough to possess wealth of over two lakhs of rupees as an individual, you come under this tax. This is a graded tax. From two lakhs to twelve lakhs of rupees, you pay half per cent on your wealth; from twelve to twenty-two lakhs, one per cent; and over that you pay one and a half per cent. This'half per cent or one per cent may look small. But one per cent on capital is something different from paying 6 per cent on income. If one assumes that investment should bring in a reasonable return of six per cent, one per cent tax on wealth is a severe burden.

The taxes are generally not paid by selling off property. Therefore, the Wealth Tax becomes an incidence on the assessable income for the year. If the incidence of Wealth Tax is added to income tax and super tax, it casts a very heavy burden. I know a number of cases where after meeting all the dues on income tax, super tax and wealth tax, not only does 100% of the assessable income for the year disappears, but one is compelled to sell a part of his capital to meet tax obligations. Therefore, when wealth tax works out to that sort of incidence, ethically it can never be justified. It is nothing else but capital levy. Capital levies have been imposed in different countries of the world, but they are not of an annual character. They are imposed during some national emergency or project and collected one year. The result of the Wealth Tax on individuals would be particularly hard on people at the age of 25, 30, or 35. If the average life span is 60 years, for 35, 30 or 25 years to go on paying the Wealth Tax would simply mean impoverishing the man. If it was only that, one can understand the hardship involved. But there is also the effect on the national economy.

These people have resources today that can help the promotion of industries and that can even be invested in Government securities to finance Government projects. But, if year after year, their capital resources are depleted, then the only thing that can happen is that the aggregate of national income will go down and the national economy will suffer.

The Wealth Tax on companies is essentially unsound. It is also ethically unjust. It is essentially unsound in that whereas we have always been told that the companies should pursue a conservative policy, plough back their profits so that they can expand their business, the levy of Wealth Tax diminishes every year the resources available to them. It is ethically unsound in that the wealth of the company is also the wealth of shareholders. For instance, if you are a shareholder of the Tata Iron and Steel Co., the value of the shares you hold is part of your wealth which you declare. The value of your shares will naturally be determined by the assets of TISCO. Whereas you pay individually tax on your

wealth which includes the shares, the company is also called upon to pay the Wealth Tax on assets which belong to shareholders. This is a vicious form of taxation. I have recently seen suggestions made by very important people — as a matter of fact bv the members of the Government — that they are satisfied that Wealth Tax on companies cannot be justified, but then they say, if you suggest any alternative source the Wealth Tax on companies can be removed. That very argument shows what little justification there is for the introduction of Wealth Tax on companies and it confirms mv earlier observation that one of the two considerations for the imposition of these new taxes is the collection of maximum revenue. What impact it has on individuals, corporations and on the general economy seems to be of little consequence so long as maximum revenue can be collected.

There is the Expenditure Tax. This is most obnoxious of the new taxes. It is a tax paid after one has met all the liabilities to the State — income-tax, super-tax and wealth tax. When one is left with a certain amount of money after paying these taxes, even here the State says, "You shall not spend the balance of your income without paying a tax". A friend of mine who is a research student tells me that the Expenditure Tax was levied in the Roman Empire in the first century B.C. by Emperor Augustus. I would have credited our Government with various other things but not with such a fine historical sense. At least after first century B.C. it has been revived here.

Then we have the Estate Dutv. Till now it was leviable after death on property worth a lakh and over at steeply graded rates which rise from 4 to 40%. It is now proposed to be levied at the figure of Rs. 50,000. So you pay tax while you live, and you pay tax when you are gone too.

The Budget for 1958-59 brings in a Gift Tax. Any gift of over Rs. 10,000 in one year will be subjected to a Gift Tax. There must be some very loving and devoted husbands who must be the authors of this law because an exemption is made for a gift upto one lakh of rupees to one's wife. There are two particular clauses in the Bill which deserve special attention. One clause is quite outrageous.

When I drew the attention of some of the authorities in New Delhi to this clause, they themselves were shocked, suggesting thereby that though the Gift Tax Bill has been published they had not seen it. This clause says that any political contributions made by private parties, private firms and private limited companies, during the assessable year, will be treated as a gift. Can there be anything more outrageous than that the persons who went about the country begging their friends for financial support for their elections and who are installed in power today should ask their friends who helped them to pay now a tax on that contribution?

There is another serious thing in this Bill, which will have some impact on our economy. This relates to communal charities. I have felt for a long time that the Government in its zeal for planned development is taking too much upon itself. There are a number of social services which could be provided voluntarily by the community itself. As a matter of fact, it is being done on a fairly substantial scale even in a poor country like India. It is a natural instinct that a Parsi or a Hindu or a Muslim or a Christian first thinks of his own community. After all, the motive to charity cannot be guided by law or compulsion. The clause relating to communal charities will have very serious repercussions not only on the expansion of such charitable institutions like schools, dispensaries and hospitals, but it might endanger the maintenance of a large number of existing institutions. But the authors of such taxation appear to follow the maxim "Who cares?"

Apart from all these direct taxes, the new pattern of taxation consists in a wide and extensive field of excise duties. One has only to take a look at some figures to appreciate what excise duties mean today compared to what they were some years ago. In the last ten years revenues from excise duties rose from Rs. 50.63 crores to Rs. 304 crores which is the estimated yield in the Budget for 1958-59. These excise duties are imposed on a number of commodities — sugar, cement, steel ingots, tobacco, patches, cigarettes, paper, vegetable products, motor spirits, etc. Most of these products come within the necessaries of life. If there is any class of

people that has been hit more than other, it is the middle class and the lower middle class who have been crushed by these excessive excise duties. The Government does not appreciate sufficiently the plight of the middle class in this country. In any society, and particularly in a democratic one, the middle class constitute the backbone of the society. The Government does not yet realise the possible serious political repercussions of casting such heavy burden on the middle class. It does not understand that the worm sometimes turns.

The above is a rough picture of the new pattern of taxation. The whole economy of the country today is dominated by five-year plans. We are in the midst of the Second Five-Year Plan. It is understood that the least the Government wants to do is to spend Rs. 4,500 crores in five years. In the first two years about Rs. 1,500 crores have been spent and, therefore, the balance of Rs. 3,000 crores has to be spent in the next three years. I understand the Planning Commission was recently asked to prepare a memorandum showing the Government the availability of internal resources so that the Government at the end of the Second Plan will have spent Rs. 4,500 crores. The Planning Commission has been practically ordered to indicate how these resources could be got together. In order to enable the Government to spend Rs. 4,500 crores by 1961, the Commission is understood to have advised that further taxation to the tune of Rs. 125 crores would be necessary in the last two years.

Planning in this country is becoming pig-headed. In spite of increasing evidence which is forthcoming every day on the result of the implementation of this Plan so far, in spite of the fact that some realism has dawned at last in New Delhi, still sufficient realism has not come to authorities to realise the dangers of spending Rs. 4,500 crores over *a* period of five years. But since the ***hookum*** has come from the highest that Rs. 4,500 crores must be spent by 1961, people must be prepared for additional taxation.

The main object of all planned development is to raise the standard of living of the masses. "Raising the standards of living of the masses" has become a hackneyed phrase, How is the standard of living of the masses raised? It is not by asking every rich man to distribute every naya paisa he has. There is an interesting anecdote, which relates to Rothschild the Banker. One day, five members of the Communist party went to his office and told him that there are about 37½ million people in France, most of them having nothing like the wealth that he possessed. They asked: "Don't you think it is desirable that an average man in France should be richer even if it means that you completely disappear?" This hardworked businessman said: "I entirely accept your view. I accept your figure that we are 37½ million people in France. Will you give me an estimate of my wealth?" So these people quoted an estimate. "Well," he said "alright, we will divide my wealth by 37½ million." He worked out the figure, took out a few francs from his wallet and distributed to each of them 25 or 30 francs. He then said. "There is your share of my wealth." If all the rich people in this country were compelled to surrender every naya paisa of their wealth, and if that was distributed to 370 million people in India each one of us may barely get a few naya paise. Therefore, it is evident, that the standard of living of the masses cannot be raised by merely dispossessing the rich. The standard of living can only be raised by increasing production and wealth in the country. If you follow the first method, you distribute poverty and not wealth. Therefore, the only sensible method is to increase production and wealth in the country so that every one can have a better share of the national income than what one is getting now.

If you increase savings, there will be more production. More production means more employment. On this subject, let me allow the Law Minister of the Government of India, Mr. A. K. Sen, to reach you through his article in the "A. I. C. C. Economic Review", an authentic official organ of the Indian National Congress party. In this article which appeared in the issue of November 15, 1957, Mr. Sen has first reviewed the economic situation. He has tried to compare conditions in India with the advanced countries of the West. He has compiled — I am sure he could not have

done so without the assistance of Government departments — some very interesting statistics on the basis of which, and on the basis of information which as a member of the Government of India he has access to, he has come to certain conclusions. Mr. Sen has examined what is happening in the sphere of individual and corporate savings in the light of the new pattern of taxation. It is seen from his statement that as far as India is concerned there is a tendency for an increase in the ratio of taxes to corporate profits, and a decline in the ratio of corporate savings to corporate profits: In the case of the United Kingdom, he says, both the ratio of taxes to profits as also of savings to profits have increased. Mr. Sen further observes that between the years 1951 and 1955, while the ratio of net new issues to total corporate funds increased from 17 to 18% in the U.S., they stagnated at 5% in India. Mr. Sen says the figures of the ratio of gross capital formation to gross national product are 7% for India taking both private and Government investment, 24% for Japan, 24% for Germany, and 18% for the U.S. He concludes that the main problem before India is to accelerate her rate of capital formation. Unless that is done, it would not be possible for India to increase the level of employment at a rate higher than the gross population, keeping in view the tremendous backlog of unemployment in the country.

On the question of personal savings, Mr. Sen has come to the view that ultimately the flow of funds to corporations or to the Government depends upon the savings of individuals Even today quite a substantial portion of the sources of corporate investments comes out of fresh capital which is saved. As far as India is concerned, more emphasis is to be laid on personal savings rather than on corporate savings as the proportion of corporate income to national produce is only 3% in India and the remaining 97% is from individual income.

Mr. Sen fears that if this rate of taxation continues, the famous law of diminishing returns will set in. This is a law not enacted by any Parliament. It has evolved out of the experience of human behaviour over a period of generations. It says that if you levy taxes beyond a certain level, instead of collecting more revenue, ultimately you will collect less revenue. Such trends indicate that in India 'the sources of personal income are drying up and the policy of increased progressive taxation has not been yielding increased revenue. Mr. Sen says that the yield from income tax indicates the operation of the law of diminishing returns. The structure of taxes is tending to reduce the incentive of entrepreneurs to work more and earn more. One instance of incidence of tax on incentives is a tax on building which is so high in certain States that there is no incentive left to construct new buildings or even to maintain the old ones.

I would like to expose a practice of giving comparative figures of this country and other countries of the world, particularly the advanced industrialised contries of the West, with regard to taxation. This game was started by the ex-Finance Minister, Mr. C. D. Deshmukh. In making those comparisons, what is not generally appreciated are the two fallacies underlying such comparisons. One is that unless taxation is related to *per capita* income, the comparison has no meaning. For instance, per *capita* income in the United States is nearly thirty times that of India and in the United Kingdom nearly 13 to 14 times. Therefore, in comparing the burden of taxation in India and these two countries, there should be a weighted average. Another fallacy relates to the number of people paying income **tax.** In a total population of 370 millions, the number of assessees for direct taxation is less than one-third of one per cent in India, whereas in advanced industrial countries, 30 to 50% of the population are the assessees to direct taxes.

The standard of living in the country can be increased **by** more production and more employment. One of the targets in the Second Five-Year -Plan is to increase employment. My experience in daily life is that I have never seen so many people seeking jobs in my 33 years of business career. This may not be complete evidence of growing unemployment, but the fact is there.

So far as production is concerned, it is undoubted that industrial production has gone up. I believe that it is an

achievement of the private sector that in spite of all difficulties if there is one hopeful feature in the economy of the country today, it is the maintenance of industrial production. I must sound a warning, however, that while I have advocated and personally supported the Government in import restrictions, which have become unavoidable because of the mess which the Government has landed the country into as regards foreign exchange, they will have a depressing effect on the tempo of industrial production. For the last few weeks, I have been hearing reports from a number of industrial units that owing to acute shortage of certain materials, particularly steel, several engineering units in the country have to curtail their capacity considerably. Some of them may even have to close down. But, so far, industrial production has kept up and that is the only hopeful feature in our economy.

The public in general has believed that the new taxes were imposed following the recommendation of one Prof. Kaldor, who came to India to advise the Government. It has now been reported that Prof. Kaldor came to New Delhi a few days ago, perhaps to examine the state of the health of his babies. It is gathered that he has expressed great amazement at the way his recommendations have been implemented in a distorted form. He is reported to have told some friends in New Delhi that the basis of his recommendation was that after all the new taxes, a man in the highest income bracket would be left at least with 26% of his total assessable income for the year. As these new taxes are levied now, there will be a number of cases in which not only no part of the assessable income will be left, but these assessees will be called upon to pay substantially higher than 100% of their total assessable income. The effect of this on the savings of the country can be well imagined.

I have not come across a single country--of course, I am not referring to Soviet Russia—where the total burden of taxation even on a single person in that country would be anything like 100% of his income. Whatever be the demands of the Second Five-Year Plan, it lacks complete ethical justification for any taxation structure to levy taxes where even a single assessee is deprived of his total assessable income for the year. If for nothing else, on this ethical ground the new pattern of taxation stands condemned.

Some of these taxes have been levied with vague estimates of the yield they will give to the Exchequer. When the Estate Duty was first levied, the Finance Minister of those days estimated an yield of anything between Rs. 5 crores to Rs. 15 crores. The results for the last four years are:

1954-55	Rs. 0.81 crores
1955-56	Rs. 1.81 crores
1956-57	Rs. 2.11 crores
1957-58	Rs. 2.52 crores

New Delhi and Income Tax Officers must be greatly disappointed that rich people are not dying so quickly. The Wealth Tax which was levied last year was estimated to yield Rs. 9 crores. It is now known that the total collections till March 31, 1958 were only Rs. 6½ crores. I am not going to be beguiled by this because I believe that on Wealth Tax the Government will collect much more than it estimates.

The main effect of all these direct taxes are so obvious that I hardly need point them out. The scope for savings has been definitely curtailed. If you need evidence for that, you have only to watch prices of stock exchange securities. The Reserve Bank of India prepares index number on this. Whereas the index number for variable dividends on securities was 121.2 in 1956-57, in February 1958 it had dropped to 96.5. Preference shares which were always recognised as conservative investment, which have been held by dependents and widows, have suffered the most. Because of the new pattern of taxation the yield on equity shares is anything between 7 to 9% today and naturally all those who held Preference Shares and considered them sound and conservative have today lost anything between 25 to 40% of their capital. Companies are finding it increasingly difficult to make new issues of capital; small savings have been going down according to the Economic Survey which was issued with the Budget. The Survey has shown that while on the estimate of the Planning Commission the Government must have collected Rs. 100 crores each year in small savings, they collected last year Rs. 66 crores. The final figures for the first ten months of the current year are shocking in that they are considerably lower than the estimate. Whereas the Planning Commission estimated that the Government should be able to borrow Rs. 140 crores a year, net receipts on public borrowings last year were Rs. 68 crores. That shows to what extent people arc able to save money and invest.

That there is a certain amount of investible surplus in the country there can be no doubt about. This is indicated by the fact that the time deposits of banks have been on the increase in the last twelve months. What I deplore most is not merely the capital depreciation the people have suffered in their investment, but also the psychological harm which has been done to the economy of the country in that where even investible surplus is available, people have no confidence in the future and, therefore, they will not invest. That is the greatest harm done to the economy of the country by the new pattern of taxation.

The six-fold increase in ten years in excise duties has had two particular effects on the economy. First, prices have risen all-round accentuating the inflationary pressure in the country. Second, it has hit the middle class and people with fixed income, like pensioners and people dependent on contributions such as those made by family trusts. While the Government goes on piling up excise duties, it is surprising that it does not recognise an important economic fact, that is, there is something like consumer's resistance. You can go on selling a commodity at a reasonable price, and people will buy it. With more incomes, people will buy more. But if you raise the price of commodities to a certain level, there will be a certain amount of resistance from consumers. The experience with regard to cotton cloth in the last two years should convince anyone about this.

Till September 1956 there was a booming market in cloth. The production was going up, mills were selling cloth very easily and on an average a mill had hardly two to three weeks' production in stock. The very steep increase in excise duties in September 1956 completely changed the position. It has generated a very fierce type of consumer's resistance with the result that not only the prices have come down to a level lower than what they were in September 1956 but the demand for cloth has gone down substantially. The result is that cotton mills are carrying much larger stocks than they had ever carried in their history. Moreover, about 26 mills have already closed down and more are likely to close down despite some relief which was recently granted in excise duties. This experience of heavy excise duty on cloth ought to open the eyes of the Government and make it understand that excise duties cannot be increased indefinitely without causing certain reaction on the general purchasing community.

I observed earlier that two considerations, namely, planned expenditure and the plugging of all loopholes of evasion influenced the adoption of the new pattern of taxation. So far as planned expenditure is concerned, even the Finance Minister has admitted that the total contribution that the surplus tax revenue made to the spending of about Rs. 800 crores in 1957-58 was Rs. 122 crores. So far as the plugging of loopholes is concerned, it is going to be a tug of war between tax dodgers and the Government. Human nature being what it is, if the burden of taxation is unreasonably high, human ingenuity will find out new devices of avoiding taxes. The continuous phenomenon of smuggling of gold holds out a lesson. In spite of all the efforts made by the Government, gold continues to be smuggled into the country. The very fact that the price of gold and silver goes on rising is an indication as to where money is going instead of going into the Government coffers.

I want to bring to the Government's attention a very wise saying of a former British Chancellor of the Exchequer. From his experience, he found that money fructifies better in the pockets of individuals than in the Government Exchequer. The situation today is sufficiently gloomy. If the Government persists in its present policy, there will be further and continued deterioration in the economic situation which will completely defeat our common objective of a rapid and large-scale economic development of the country. I would, however, like to conclude on a note of hope.

We have now a new Finance Minister. He is not an expert but I have a hope that at least a fresh mind has been brought to bear on a very difficult and delicate problem. As an experienced administrator I am sure Mr. Morarji Desai, the new Finance Minister, will make a practical approach to the problem of taxation I have discussed this evening.

Text of a public lecture delivered in Bombay on April 16, 1958.

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

— A. D. Shroff

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