NEW TAXATION PROPOSALS

BY

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"We are neither omniscient nor infallible, nor are we so rigidly wedded to any course of action as not to alter it if it becomes apparent to us that we are mistaken.

"It is for this reason that we continuously welcome the people of India and our friends abroad telling us when and where they think we are going wrong."

T. T. Krishnamachari
Finance Minister, India

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Before the Taxation Proposals made by the Finance Minister on November 30, 1956, are examined, it is very necessary to have some picture of the background of the economy of the country in order to be able to make a proper appraisal of their implications.

The Finance Minister, in a fairly lengthy statement, tried to justify the necessity of introducing his proposals at this time of the year. He referred to a number of factors which have been affecting our economy in recent months. He referred to two important factors: One was, the rise in price level during the last few weeks. He suggested either the actual setting into motion of the inflationary spiral in this country, or, in the words of the Finance Minister, it is nothing to be alarmed about

* **Based on a speech delivered by Mr. A. D. Shroff to the Democratic Group on Monday, November 30, 1956, in Bombay.**

immediately, but something of which notice must be taken. The Second important factor, to which he referred, was the serious depletion in our Sterling Balances. Quoting his own figures, our Sterling Balances during the last 12 months have declined by a little over Rs. 200 crores. We are still in the first year of the Second Five-Year Plan. The Second Plan envisages extensive development, and particularly in heavy industries, which necessarily implies purchases of very large quantities of foreign plant and machinery and also some of the basic raw materials like Steel and Cement.

The decline in Sterling Balances, although the Finance Minister assured the Parliament is not and need not be a matter of alarm, is a factor of considerable importance, which in my judgment is going to affect the implementation of the Second Plan. Under the arrangements recently made between the Government of India and the Reserve Bank, out of the Sterling Balances, a minimum of Rs. 400 crores has to be maintained as cover against our note issue. The amount of Sterling Balances standing to our credit during the last week was Rs. 542 crores, which leaves a balance of Rs. 142 crores to be withdrawn. It is true that this balance can be augmented by any foreign economic aid which we might receive like the very substantial aid received from the U. S. A. a few weeks ago, and the loan which the World Bank may agree to for some of the capital projects in the Plan. In the last resort, we can always rely on our membership

of the International Monetary Fund from where sometime back we had drawn Rs. 100 crores and which we subsequently repaid. But we would be entitled to draw Rs. 100 crores from the International Monetary Fund. To a certain extent, it may be true that the fall in sterling balances need not immediately cause alarm. But considering the fact that what we have imported during the last few months in the way of implementing some of the heavy capital projects under the Plan is only a small proportion of what will be required for its full implementation, I am afraid that after 18 months or two years we shall certainly run short of foreign exchange resources,

The general public does not sufficiently appreciate one very significant implication of our drawing on sterling balances. The drawing of sterling balances automatically means the withdrawal of so much money from circulation. Rs. 200/- crores of sterling balances means that the Government make available to the importers in India foreign exchange of an equivalent value of Rs. 200 crores, which is shown against our account. It is necessary to keep this aspect in view in order to be able to understand subsequently one of the very important contributing factors towards an extreme and exceptional monetary stringency which is being experienced for the last few weeks, both in Bombay and in Calcutta.

The rise in prices is certainly a serious matter, particularly those of foodgrains and cloth. In a poor and economically backward country like India, the

cost of living is mainly influenced by the movement in prices of foodgrains and cloth. It is a matter of some gratification that the framers of the Plan and leaders in Government have awakened to the realisation of the fact that, unless agricultural production is substantially increased during the next five years, scarcity of foodstuffs will cause a considerable rise in the general level of prices and it will considerably upset the whole economy of the country, apart from automatically increasing the cost of financing the Plan. As a matter of fact, in the last few days we are told that expenditure in the Public Sector in the Plan will not be of the order of Rs. 4,800 crores, but it will increase to Rs. 5,300 crores. Apart from the rise in prices internally, the international situstion has also been adversely affecting us. The closure of the Suez Canal has meant increase in shipping freight and insurance charges, and unavoidable delay in the arrival of our imports. In any case, the basic fact is that the Public Sector would require Rs. 5,300 crores and not Rs. 4,800 crores as was originally laid down in the Plan.

The Plan has also laid down the various methods of financing it. After making all provisions, it was laid down in the Plan that it would involve an additional taxation of Rs. 400/- crores in a period of five years. One could hardly have believed his eyes, while reading that it is not Rs. 400 crores of taxation which will be required, but Rs. 1,300 crores. This is particularly so because the present Finance Minister has taken the view that deficit financing

to the tune of Rs. 1,200 crores, which was partly to make good the gap between the available resources and the Plan outlay, is very dangerous in practice and, therefore, the extent of deficit financing should be substantially reduced and the gap made good by additional taxation. This is mainly the background under which he has thought it necessary to introduce his new taxation proposals.

The basic factor, therefore, before us is whether the implementation of the Second Plan, involving a capital outlay of Rs. 5,300 crores in the Public Sector, is in the best interests of the country. It is not only my judgment, but that of a number of independent thinking people, that from the very start the Plan was so formulated that it was not related to the realities of the situation in our economy. It has been sufficiently made clear now that the country simply has not the resources and has not the capacity to collect the resources to carry out the Plan Frame. The Congress Party appears to have made it a question of prestige that somehow or other the Plan must be fully implemented.

At a speech delivered in Calcutta at the meeting of the Associated Chambers of Commerce on December 10, the Finance Minister said that democracy in India would suffer if the Second Plan failed. My only reply to the Finance Minister is that an enforced implementation of the Plan will mean disappearance of democracy, particularly in the economic life of India. I am reminded of a very wise statement made by a

British statesman some years ago in the discussion of a problem confronted in his day. He said that wise men are not slaves of dates. Heavens are not going to fall if the Second Plan is not carried out in five years, but instead in six or eight years. On the other hand, so far as one can independently foresee, there is a strong likelihood of the general economy facing a very serious, widespread break-down which will affect every section of the community. Some years ago, a British Finance Minister in India said that making a budget in India was a gamble in monsoons. The remark can be slightly varied in the present context today. Now it is a gamble and a desperate one in Planning. That is what. budgetting in India means.

Coming to the specific taxation proposals. quantitatively it is nothing at all. If all the estimates of the Finance Minister under the new proposals fructify, he would be able to collect in course of 12 months Rs. 16 crores more than what was estimated to be collected in the last budget. During the current year, i. e. by 31st March, the general estimate is that Rs. 2 to 2.5 crores will be collected. But he said he would be able to collect Rs. 4 crores. So quantitatively that is not much. But psychologically, the introduction of the new taxation proposals in the middle of the year and of this nature create further uncertainty. What is needed today in the country is to improve the general economic climate in the country, a climate that would rouse countrywide enthusiasm for co-operative effort to carry out the Plan. The taxation proposals defeat that object. On the contrary, these

measures are bound to create uncertainties in the minds of men as to what is going to happen after next two or three months. As a matter of fact, the Finance Minister has told the Associated Chambers of Commerce that in the post-election budget he could promise no relief. Considering however the total amount that he is going to collect against this extra Rs. 1,800/- crores of new tax revenues which is to be collected, he has made a very serious psychological error in actual practice. It has created new hurdles in the implementation of the Plan.

Let us first consider the Import Duties. It is true that with the precarious position we have in foreign exchange resources, the Government should take immediate and necessarily drastic steps to restrict imports. The present tempo of imports cannot be sustained by the country, and, therefore, restriction of imports is fully called for. But here the Government is caught in a very serious dilemma, as most of the imports are for Government account and they must continue under the development programme of this magnitude and of an essential character. These imported articles cannot be restricted without jeopardising the effective carrying out of some of the projects in the Plan. But generally speaking, the situation is such that it does call for drastic restriction of imports. From that viewpoint, one cannot object to what is being proposed under the new taxation proposals, although the steps he has taken are of a limited character.

The only important industry for which a new

problem has been created in the Art Silk Rayon and Fibre. The art silk yarn industry is in the initial stage. The units which have come into existence are not yet in a position to cater adequately to the Indian demand and the excise duty – though there is a countervailing increased import duty – is going to be a serious handicap. Encouragement received so far by the indigenous industry would to that extent be reduced. But under the new import duties, there is no scope for much revenue.

Then we come to direct taxation. These proposals are of three different types.

The extension of the principle, which the former Finance Minister, Shri Chintaman Deshmukh, introduced in his last budget, of subjecting dividends of joint–stock companies to what is described as penal super–tax. The justification for that was that we are living in a period of very large development programmes wherein profits of a number of industries would rise, whether we liked it or not; and at a time like this when inflationary pressures were set in motion it was necessary to reduce the surplus purchasing power in the hands of the people. The present Finance Minister has extended that principle and has made super-tax heavier than what it was in the last budget. One of the objections pointed out last time was the inequity of levying super–tax on dividends. It is very necessary to reiterate some of the criticisms as the same will be more valid today.

In the first place, the imposition of the penal super-tax on dividends betrays a lack of real understanding on the part of our financial pandits in Delhi as to how industries are started and capital formation takes place. To think that to start and run ventures only paid-up capital is required betrays a complete mis-understanding of our industrial structure. There are companies which are in existence for 20, 50 or 70 years and they could never have developed their capacity for production or capacity for earning profits if the total capital used by them was paid–up capital. Therefore, the basis itself is wrong. The right basis should be to calculate the dividends on the capital employed in the business. It is the total capital which is employed in the business that gives the business its present-day earning capacity. It should also be noted that conservative, prudent management pursued by a number of joint-stock companies has led to ploughing back into the business substantial amounts of their current profits and building up large reserves for expanding their business. It is this prudent management, which is actually being penalised today by the penal super–tax on dividends. All such taxes in the history of a number of advanced countries have shown by experience, that one definite result is to encourage wasteful expenditure in joint–stocli companies. This tax on dividends also ignores another important factor in the working of our joint–stock companies. In the initial period a number of industries particularly those of a complicated character, are unable to declare any dividend at all for shareholders

for a number of years. Take for instance, the Tata Chemicals. After 17 years of bitter experience and hard struggle that company was able to pay its shareholders dividend for the first time. People in Delhi do not appear to be sufficiently informed as to how our industries are working, progressing and prospering. Particularly the case of the investor goes very much unheard.

Matters like this should receive the immediate attention of the Bombay Shareholders' Association in Bombay. Shareholders are a special class of people. It is they who make possible the establishment and the running of industries. These are matters which directly and vitally affect them, and unless they represent their case and viewpoint to the authorities concerned they are likely to suffer more.

If at all this tax is to be justified, it should be on a more logical and scientific basis. One aspect should be that we should take the average of three years. If that average exceeds something over 6, 10 or 18 per cent., then you can subject them to penal tax. In the case of new industries, the first three years ought to be completely exempted from payment of penal taxation.

One particular aspect with regard to penal super-tax is in respect of what are called Section 23A companies. These companies are subjected to additional taxation - another penal taxation. The Income-Tax law requires that after ascertaining your

profits, you have compulsorily to distribute 60% of the profits to shareholders. If you do not distribute 60% of the profits, then the difference between the amount actually distributed and the amount not distributed under 60% is subjected to the penal super-tax at four annas in the rupee. The present Finance Minister goes further and says that penal taxation shall be six annas in the rupee, but with the relief that the compulsory distribution shall not be 60% hut 50%. This is one aspect of Income-tax law, which is going to cause a lot of harm to development of industries in the country.

This subject came up for consideration by the Matthai Commission, and I am sorry to say that one of the matters which did not receive complete or thorough examination at the hands of the Commission was Section 23A of the Indian Companies Act. In actual practice, Section 23A companies can easily be classified into 3 categories. I have been urging for some time that Sec. 23A should be amended and three different categories of companies under this Section should be made as under :

(i) Investment Companies,
(ii) Manufacturing Companies
and
(iii) Purely Family Investment Companies.

The investment companies are not private companies, but of a public character, where no particular sectional interest is involved. Under the present law, these investment companies are called

upon to distribute 100% of their profits, The difference between 100% which must be distributed and that which is actually distributed is subject to a penal super-tax of eight annas. Then there are a number of large, medium and small-sized manufacturing companies. It is very necessary to give a little background of this category of Section 23A of the Companies Act.

In my experience I have come across a number of people, small in their ways and means, who promoted small industries, 20 or 25 years ago. When they were not able to get all the capital they wanted from the investing public, what they were compelled to do under the circumstances was to put their own money and some money of the members of their family, and make one or two friends contribute something, thereby getting together to promote companies and start working. Those of such companies, which have in course of time been able to build up substantial reserves, - but not sufficiently known to the investing public - must be spared from the mischief of Section 23A. Such businesses, which have been built up for over a period of years through the personal and pioneering efforts of small men are companies in which the general public and the investor are not interested and, therefore, 60 or 70 per cent of the capital is held by one, two or three persons. But! these are genuine cases of industrial concerns by small men and it is most unfair and inequitable that those people should be penalised under Section 23A. What has happened is that under Section 23-A, some

of these are being denuded of the resources which would be made available for expansion. Three or four months ago, I pointed out the harshness of the operation of Section 23A, because in actual experience we find that some of the people could be compelled to close down their established business. These are actually being squeezed out of existence by the harsh operation of Section 23A. I think, therefore, the Government ought to pay some attention to this and amend Section 23A by putting them in a different category, so that small businesses built up in this fashion may further be encouraged.

Now let us consider the new Capital Gains Tax. Here also, viewed dispassionately, in a time of inflation when prices are continuously rising and profits are also continuously on the increase, it may well be argued that the State is entitled to have a share in profits which come to business or persons and which may to a certain extent be described as unearned surplus.

The Matthai Commission, which examined the question, observed that normally capital gains tax should not be levied. The Commission also pointed out that as a result of the experience of the capital gains tax levied by Mr. Liaquat Ali Khan in 1947, the tax was withdrawn in two years because the actual revenue to the Government was very limited. The Matthai Commission did add that if a situation arose when profits were continnously increasing and prices generally were continuously rising, the State may

be justified in appropriating a part of the unearned surplus for the State. This is the theoretical background.

The rate at which capital gains should be taxed will be the normal income-tax rate; that the first Rs. 5, 000 will not be subject to tax and the rest will be subject to tax at the normal income-tax rate. The Finance Minister in his proposal has made some very important departures from the basis adopted by Liaquat Ali Khan when first introducing gains tax. In the first place, the limit was Rs. 15,000, i. e., you could have capital gains up to Rs. 15,000/- and not up to Rs 5,000. Over Rs. 15,000 there were slabs. The first slab was, up to Rs. 50,000 one anna and on a much higher slab 2 annas and then on a capital gains of more than Rs. 5 lakhs, four annas. Today what will happen is that for anything over Rs. 5,000, one will have to pay the full income-tax rate of 4 annas. The greatest objection to the Capital Gains Tax which is proposed to be levied, is that if an asset was compulsorily acquired by the Government, as it happens when Government nationalises industries or businesses, and if in the compulsory acquisition by the Government cne makes a capital gain, even then one is liable to pay the tax. Serious notice should be taken of this. April 1, 1956, has been put down as the date from which if one makes any capital gains one will be subject to the tax. Insurance companies have been nationalised and if their shareholders get anything over what they have paid or as on 1st January 1954, they will be subject

to capital gains tax. In nationalising business we have bitterly complained that the compensation given is not adequate. If after paying inadequate compensation, the incidental gains that may arise as a result of compulsory acquisition are also subjected to capital gains tax, it would amount to reducing the compensation by 25%. I consider it as most inequitable. I have no doubt that people who have been taken unawares will certainly pay capital gains tax in the next year or the second year, but I very much doubt if capital gains tax over a long period can contribute anything substantial to the revenues of the Government.

The Finance Minister appears to have said -"Well what is there to be exempted from capital gains? That is the only direct tax you have to pay." If you take the very high rate of direct taxation to which we are subjected, its cumulative effect will certainly make a serious drain on capital formation in this country. The only consolation is that, in introducing his new proposals, the Finance Minister himself has admitted that the rates of direct taxation have gone so high that if you put them up higher the law of diminishing returns would begin to operate. That is mere consolation. I may refer to the statement of the Finance Minister made in Calcutta. He said that his new proposals are a first step towards the re-constructior, of the tax structure in the country.

The most serious of the new proposals is the proposal for what is called compulsory deposit. The

proposal is that any company, including every type of business, if it has accumulated reserves, then 25% of the accumulated reserves over this entire period - 50 years, 75 years, 100 years, which are not represented by fixed assets of the Company, must be compulsorily deposited with the Government or the Reserve Bank; secondly, out of every current year's profits, after deducting taxation which is payable and deducting the dividends which were paid during the previous year, and if the surplus exceeds Rs. 1 lakh, then 75% of the surplus must be compulsorily deposited with the Government. In arriving at profits, depreciation shall not be deducted, which means that 75% of the depreciation reserves every year will have to be compulsorily deposited with the Government. This, I consider, is the severest blow to the private sector in the country.

The Prime Minister said very recently in Calcutta that the private sector has a very important part to play in the implementation of the Second Five-Year Plan, and it is to be encouraged. The sincerity of the Government is subject to some doubts.

The implications of the compulsory deposit should be very clearly understood, particularly at a time like this when money and credit are very stringent. If companies with accumulated resources unrepresented by fixed assets are called upon to make these deposits, one of the two things will happen - either the existing companies will have to sell out some of their investments, which will be a difficult thing; or they will

have to go to their Banks to raise money. And with some inside knowledge of what is happening in Banks today, I can point out that on the whole the Banks have-just not the money to lend.

This sort of compulsory deposit is a sort of a forced loan. If the proposal is fully carried out, it is likely to create a very serious monetary crisis in the country. Of course, it is true that the Finance Minister has said in Calcutta speech, perhaps after a second thought on his part, that the provisions would be most liberally administered. But the fact is that if the proposals as they stand are carried out, there will be considerable diversion of the available resources in the private sector to the Government. As a matter of fact, the Finance Minister has been very frank in his statement while introducing the proposals. I have always tried to take an objective view. If we cannot do away with the proposals, at least there are a number of ways in which the proposals can be modified. For instance, in the first place, if the Government does finally decide to have the forced loan from the private sector, as the Bill stands, it applies to every company, including Banks. It is unthinkable that Banks can operate normally and carry out their obligations. I take a more charitable view and presume that these proposals in the first place will be restricted to manufacturing companies, and not to banking, insurance and investment companies. Then, in the case of companies which have already a rehabilitation, modernising or expansion plan in ,operation, such

companies ought to be exempted. Similarly, in respect of companies which have undertaken investment of their spare funds in projects which are approved by Government, such companies ought to be exempted and particularly in the calculation of surplus for the current year appropriation for depreciation should be deducted. Unless that happens private sector would find it increasingly difficult to carry out its normal work. I consider this as the most severe blow to the private enterprise.

Recently I spoke on "Has Private Enterprise Failed?". The Finance Minister had charged the private sector with failure to carry out its obligations. I pointed out a number of handicaps to which the private sector is subjected in this country, but perhaps no handicap eould be of such serious consequence as the diminution of the resources of the private sector through these forced loans.

A passing reference to the new proposal for Stamp Duty is needed. There is a stamp duty at present on Bills of Exchange, which is 2 as. per Rs. 1,000. The Bill proposes that Government should be given the executive authority to raise it to Rs. 10/-, which means 80 times the existing rate. Apart from the fact that this duty is of a regressive character, it raises a very fundamental issue. Normally proposals of this character are subjected to the scrutiny and control of the Parliament. Are we to assume that this power has been in advance vested in the Executive authority to put up the present size of the Stamp

Duty by 80 times ? This is a further confirmation of what some of us have been telling the public of India today that such trends lead to the establishment of an authoritarian regime in this country. The increased stamp duty will surely result in increased borrowing rates. Uuder the present arrangement, Banks in order to find at least a part of the lending facilities, have to go to the Reserve Bank through the the mechanism of what is called Usance Bills. These Usance Bills have to be renewed every three months, and if the stamp duty is raised to anything like half of it, one will find in the next two or three months, banks will be compelled to raise their lending rates to the public in general.

Summing up the implications of these proposals, there is no doubt that there is a definite and confirmed trend towards a gradual disappearance of democracy in the economic field. Gradual diversion of resources from the private sector to the public sector means that the private sector will gradually disappear. The extension of public sector as a definite objective of the Government is sought to be brought about by insidious methods of subjecting private sector not only to increasing controls but even depriving the private sector of the resources that it has collected in the past.