AN ANALYSIS OF BUDGET PROPOSALS (1963-64)

N. A. Palkhivala

FORUM OF FREE ENTERPRISE
"SOHRAB HOUSE", 235 DR. D. N. ROAD, BOMBAY-1

"**People must come** to accept **private enterprise** not as a necessary evil, but as an affirmative good."

—EUGENE BLACK
Ex-President, World Bank

AN ANALYSIS OF BUDGET PROPOSALS (1963-64)

N. **A. Palkhivala**

During an emergency the fundamental rights may be suspended, but the principles of economics and the rules which regulate human conduct cannot be suspended. It is only by staring reality straight in the eye and by shedding ideological illusions that one can make a fair appraisal of the Budget proposals.

It is necessary to note that even the existing rates of taxation, apart from the increases proposed in the Budget, are 50% on companies and 87% and 84% on individuals in respect of unearned income and earned income respectively, these maximum rates being reached by individuals when the total income is Rs. 70,000. The experience of all progressive countries in the world today is that if more revenues are needed, it is imperative that the tax rates should be lowered, or in any event not be increased. The most conclusive proof of the wisdom of reducing the rates of corporate and personal taxation is provided by Japan which has the highest rate of increase in the gross national product. By effecting sizable reductions in personal and corporate taxation year after year during the last twelve years, Japan has increased its national income and its national product at a phenomenal rate which has not been equalled by any other nation. In 1957, Japan literally cut in half the income-tax payable by its middle classes. In 1962, taxes were cut in Japan by £ 116 million. The two articles on Japan in the issue of **The Economist,** London, of September 1 and September 8, 1962, might well be read with great profit by those who frame the fiscal policies of our country.

Japan, however, is not the only country which has realised that a lowering of tax rates makes the economy buoyant and gives a boost to investment and production to a point when, with lower tax rates, the tax collection actually mounts. In Germany and in France, during the last five years, direct taxes have been substantially reduced, resulting in larger net revenues for the Public Exchequer. The United States, faced with the problem of increasing unemployment and a sagging economy, proposes to have a ten billion dollar cut in income-tax during the next three years. **The Times,** of London, in a powerful editorial in its issue of January 10, 1963, observed, "The tax system needs a major overhaul to sharpen incentives." The National Institute in its Report submitted to the U.K. Government a short while ago recommended a cut of •'400 million in taxes as the only way to enhance the rate of growth from 34% to 5% per year. Mr. D. L. V. Rowe, the British expert on taxation and company law, has commented on the adverse repercussions of the high level of personal and corporate taxation on enterprise, initiative and good management. The weekly, **Time,** (January 11, 1963) observed that the soak-the-rich tone lingers on in income-tax law and it is high time the tune was changed. It is pointed out, that the way of the world is such that the really rich—those with very large assets—do not actually pay the confiscatory top rates, as the rich can arrange matters so that the money rolls in to them in forms that are partly or entirely sheltered from income-tax. The most soaked victims of the present tax structure are tax-payers of the middle classes who are bucking a headwind of very high tax rates and as they approach their earning peak, they find themselves paying tax rates which, measured by the percentage of gross income, are of the same order as those actually paid by multimillionaires. The ease and security that come from sufficient savings remain out of reach. It is noteworthy that even in Russia, the maximum rate of personal tax is less than 10 per cent and there are promises of further reduction over the next five years.

In the light of such almost unanimous economic thinking and the unfailing experience of countries which have expanded the gross national product and increased public revenues by keeping tax rates within reasonable bounds, the staggering burden proposed by the Union Budget proposals for 1963-64 must be regarded as not only unsound in principle but fraught with the gravest consequences to the

national economy. In the long run excessive taxation always fall on the poorer classes even more relentlessly than on higher classes, because it leads to inflation, unemployment and diminution in the value of hard earned savings. The Finance Minister in his Budget speech said, "First and foremost, there is the need to increase production and accelerate the pace of development. The growing claims of defence and development cannot be met except on the basis of an expanding volume of production." The correctness of these propositions is beyond question; but the Budget will have the certain effect of defeating the very objective which the Finance Minister has announced. When Mr. Morarji Desai took over his present portfolio, the national economy was sagging, production was stagnant, the share markets were demoralised and foreign enterprise was most reluctant to embark upon ventures in India. Within a very brief period, he changed the entire climate; the economy became buoyant; production increased at an impressive rate; confidence was restored in the heart of the investor; and the Indian economy was well on the way not only to stability, but to impressive expansion. This excellent work of the past few years will be completely undone by the new Budget proposals if they are fully implemented. It takes years of initiative and enterprise, care and labour, to build up a national economy; but its destruction can be compassed very swiftly and easily.

The super profits tax is beyond doubt the most insufferable feature of the Budget proposals. The Budget is intended to meet an emergency; but the super profits tax is a perfect example of how not to meet an emergency. Whoever thought of the expression "super profits tax" for the new impost must be having a supreme sense of irony. When the borrowing rate is seven to nine per cent, when debentures are hard to sell at 7% interest and preference shares carrying more than 9% dividend are absorbed with difficulty, it is ridiculous to talk of profits in excess of 6% as "super" profits. The effect of the super profits tax would be that several companies would be paying tax on their total income at the average rate of 75% or even more.

Such a rate of corporate taxation is bound to spell ruin to the national economy.

The following are some of the grave objections to the super profits tax :

(i) In substance and in effect the super profits tax will put efficiency and economy at a super discount. No doubt, the companies making higher profits must pay more taxes. This is elementary and necessarily involved in the present fiscal system which levies income-tax on a percentage of the total income. But the question is whether the more efficient unit should not only pay more tax, but pay tax at a higher rate. The Finance Minister in his Budget speech said, "There is no co-relation between the rate of tax and the percentage of profits", and he called it a "shortcoming". So, far from the absence of co-relation being a shortcoming, it is a universally recognised merit of corporate taxation. **A** corporation consists of numerous shareholders with widely varying incomes and wealth. To apply the slab system to a limited wmpany or to impose on it higher rates of tax because its profits exceed a certain percentage of its capital is really to penalise good management. It may suit some companies to prefer super profits tax to any increase in corporate taxes, if they look to their own individual interest; but at a time like this in the nation's history any fiscal measure must be enacted with an eye to the national interest and the good of the national economy. In the long run, efficiency, economy and national interest are indivisible, and a tax which penalises economy and efficiency cannot fail to have the most deleterious effect on the national interest.

(ii) The super profits tax takes no account of the fact that profits are the result not only of capital, but of labour. Trading companies, or companies which perform services like managing or selling agents or business consultants, would be particularly hard hit by the super profits tax, because in their case the profits are the result mainly, if not wholly, of labour and not capital. Under the proposed dispensation, companies with small capital or small reserves would be paying tax at a rate between 70 and 80 per cent.

(iii) **A tax** based on **a** fixed return on all capital in all industries is both unreasonable and unjust. What is a reasonable return on capital would depend on the nature of the business, the location of the industry and a variety of factors which are beyond enumeration. Even the Tariff Commission has been granting different returns on capital employed for different industries.

(iv) Companies which have passed through lean years and whose average return on capital over a period of years is much less than 6 per cent would yet be liable to super profits tax in the year when unusually better profits are made. The case of the jute industry is directly in point. That industry has passed through a number of bad years and has in the last year made good profits. The new levy would mop up the profits, leaving the industry unprepared to meet another bout of depression.

(v) **A** company may have to pay super profits tax and out of the remaining balance declare dividends on which a corporate shareholder may again have to pay super profits tax, and when the corporate shareholder in its turn declares a dividend, the individual shareholder would have to pay personal tax which may go up to 89 per cent. In the net result, in terms of percentage of profits of the first company which has earned the income, the individual shareholder would be left with a return of a little over 1 per cent. Even eliminating such corporate shareholding by one company in another, one sees that if a company pays tax at 75 per cent of its income and distributes the balance of 25 per cent as dividend among the shareholders, the net amount left with the shareholders, after paying their personal tax at the higher rates, may be only two or three per cent of the company's profits. No nation can possibly increase its gross national product or enjoy a sound economy under such insufferable burdens.

(vi) Foreign collaboration after the introduction of the super profits tax will have to be either completely abandoned or invited on terms which are excessively burdensome. New projects, vital to the progress and growth of the national economy, would have to be either given up or indefinitely postponed because of the new impost. The super profits tax will affect not only those foreigners who contribute to the capital of Indian companies, but those who charge royalties or other fees for technical know-how, technical services, etc., because in their case the profits under the agreements with the Indian companies would be equally liable to super profits tax. Without foreign collaboration, economic progress in this age of technology would be impracticable and foreign collaboration on the basis of the super profits tax would be no less impracticable.

(vii) New companies will not be formed and any attempt to attract or draw upon the investment market will be foredoomed to failure. If a new company is at all formed, it would have no reserves and would find it impossible to build up reserves. Both new and old companies would find it impossible, in many cases, even to honour their outstanding commitments and pay off the loans already obtained for capital projects. With the stagnation of economic advancement that the super profits tax spells and the growth in population still unchecked, an acute unemployment problem will be created, which may even shake the political stability of the country.

(viii) The super profits tax will stop all economic progress and sap the economic stability of the country and will brew a financial crisis of the first magnitude. The normal course of banking business will be completely dislocated and with unreturning advances, the banks will be unable to finance fresh enterprise. The banks, in their turn, will be themselves liable to super profits tax and will find it difficult, if not impossible, to build up the reserves which are not only required to be created under the convention imposed by the Reserve Bank, but are essential according to all principles of sound banking.

In short, the super profits tax, which is intended to meet the emergency, will itself create another emergency. The difference between the emergency created by the Chinese aggression and that which will be created by the super profits tax will be twofold: First, the emergency created by the Chinese was uhavoidable, whereas the second emergency will be so clearly avoidable that the marvel of history will be why it was not avoided; secondly, the effect of the first emergency will undoubtedly be surmounted in a short while, but the effect of the second emergency will be more painful and prolonged. For raising the small amount of 25 crores of rupees, which, according to the Finance Minister, will be the total super profits tax collection, as against the total revenue of Rs. 1,852 crores, the entire national economy is proposed to be put in grave jeopardy.

If the proposed super profits tax is dropped, the revenue loss to the Exchequer will be more than countervailed by the higher revenues engendered by the boost to savings, the increasing production and the broadening of the tax base which is the only ultimate guarantee of a nation's economic stability. Thus, in the net result, the public revenues will not suffer at all as a result of giving up the super profits tax.

The past record of Mr. Morarji Desai as the Finance Minister has shown that no consideration of prestige and no promptings of obstinacy will stand in the way of his altering or dropping some of the Budget proposals when correct facts and unanswerable arguments are placed before him. The Minister who scrapped the expenditure tax after it had in fact worked for five years, despite opposition to its abolition on ideological grounds, will not hesitate to drop the super profits tax if he is satisfied that it will prevent the resources and energies of the nation from flowing into productive and constructive channels.

Companies, which are the only persons caught within the net of the super profits tax, are inanimate and inarticulate creatures of the law, soulless and emotionless. If they could speak, they would stolidly ask Parliament to change the title of the Bill to bring out its true effect and rename it The Economic Hara-kiri Act, 1963."

If at all it is decided to impose the super profits tax and not scrap the Bill altogether, the following modifications are the minimum required to make the impost bearable:

I. The Act should be expressly restricted in its operation only to the period of the Emergency, as was the Excess

Profits Tax during the last war. Further, the Act should apply only to the profits of the period after the declaration of Emergency towards the close of the last year and not to the entire profits of the whole accounting year relevant to the assessment year 1963-64.

II. The rate of return on capital and reserves should be increased from 6% to at least 10%. At a time when the borrowing rate is $7\frac{1}{2}\%$ to 8%, when even Debentures at 7% and Preference shares at 9% are marketed with great difficulty, the proposed standard deduction at 6% is totally unrealistic. Even Industrial Tribunals have allowed $8\frac{1}{2}\%$ as a fair return on capital in calculating the surplus available for the distribution of bonus. A serious management-labour problem may well result, apart from the various other adverse consequences of the levy, if the present rate of 6% is retained. A return of 10% on capital and reserves would not be at all tool high, in view of the fact that even long-term borrowings are totally excluded from capital computation and a return is not given on the whole of the working capital of an undertaking.

III. The proposed rates of tax of 50% and 60% on the balance of the net profits remaining after providing for a return on capital and reserves are truly extravagant. The rates should not exceed 25% and 30% in place of the 50% and 60% set out in the Bill.

IV. In calculating the reserves on which a standard return is to be allowed, development rebate reserves should be included. Under Section 34 of the Income-tax Act, 1961, the development rebate reserve cannot be used for eight years for distribution by way of dividends or profits, or for remittance outside India, and thus the development rebate reserve stands on a different footing from the other reserves which are created out of amounts allowed in computing the taxable profits.

V. The levy of full income-tax on corporate dividend income results in the same profits being taxed three times. This works great hardship. In any event, for the purposes of super profits tax, a company's dividend income from other Companies should be excluded.

VI. No power should be given to the Income-tax Officer to disallow commission, entertainment and advertisement expenses for the purposes of super profits tax. If such expenses are not incurred wholly and exclusively for the purposes of business, they would be disallowed for income-tax purposes and no further question would arise for the purposes of super profits tax. If, however, the commission, entertainment and advertisement expenses are wholly and exclusively incurred for the purposes of business and are, therefore, fully allowed for income-tax purposes, there is no reason why they should be disallowed for the purpose of super profits tax. The Finance Minister said in his speech (para 55) that commission, advertisement and entertainment expenses would be disallowed "to the extent that there is reason to believe that they are inflated for reducing profits artificially." But the Bill itself says something quite different. Even if the expenses are not inflated for reducing profits artificially, the Income-tax Officer would still have power, under the Bill to disallow expenditure which, in his opinion, is "excessive, having regard to the circumstances of the case." Thus, the Bill proposes to give a very great and very dangerous power to the Income-tax Officer to disallow expenses, even when they are found to be wholly and exclusively for the purposes of business. This provision for disallowance must be totally dropped.

VII. Banks must be altogether excluded from the ambit of the super profits tax. It is noteworthy that banks were excluded from the ambit of the Wealth-tax Act. The banks, by the peculiar nature of their business, the absolute necessity of creating reserves and the statutory obligation to create reserves which are not allowed as deductions for taxation purposes, stand in a class by themselves, and it would be particularly unjust to impose the super profits tax on them, particularly when their operations are bound to be affected very adversely by the financial difficulties flowing from the other Budget proposals.

VIII. Under the scheme of the Bill as it stands, as pointed out above, a company may make an average profit of only 2% on its capital and reserves over a period of ten years and yet may have ta pay the super profits tax in a year in which the profits are unusually large. Therefore, it is necessary to permit a company to carry forward the deficiency of profit of one year to a subsequent year or to carry it backward to an earlier year, and the super profits of such earlier or subsequent year should be calculated after taking into account the deficiency so carried backward or carried forward, as was done under the Business Profits Tax Act.

In the field of income-tax, the taxes on registered firms are sought to be further increased by a surcharge of 20%. Unlike a limited company, a firm or partnership is not a separate legal entity. Therefore, although there is a legal basis for taxing a limited company on its profits and again taxing the shareholders on the dividends declared out of such profits, there is no reason or justification whatever for taxing a partnership on its income and again taxing the individual partners on their shares of the firm's income. The latter would be a blatant case of double taxation. No other country in the world resorts to such double taxation and charges the same income in the hands of the same individuals to the same tax twice over. The Law Commission pointed out the injustice of assessing partnerships and again assessing the individual partners on the same income. But so far from honouring the recommendation of the Law Commission, the Government has kept on increasing the levy on registered firms. In these days of complex laws and multifarious fiscal levies, it becomes all the more necessary for firms of Chartered Accountants, Solicitors, Business Consultants, etc. to have large partnerships consisting of specialists in different branches of the law. All such partnerships would now be subjected to higher taxes as partnerships, and the individual partners ,would again be subjected to higher personal income-tax and super-tax on the shares of profits received by them individually. Not one rational justification has ever been even attempted by any Government spokesman for this crying injustice. It would be difficult to find a neater illustration of Tyranny through the Democratic Process.

The Budget further aims at amending Section 40 of the Income-tax Act, 1961. It is now proposed that any remuneration paid to an employee in excess of Rs. 5,000/- per month should be disallowed as a deduction to the employer. Such a provision would be arbitrary and unjust. If the remuneration is paid out of extra-commercial considerations or is excessive, having regard to the legitimate business needs of the company, there are already provisions in the Incometax Act to disallow such excessive remuneration. Thus, the new arbitrary ceiling of Rs. 60,000/- per year will operate harshly in those cases where the remuneration is paid out of purely commercial considerations and is not excessive, having regard to the business needs of the company. The contracts of employment of directors are approved by the Government of India and they have also to be subjected to the scrutiny of shareholders. If the remuneration is found to be otherwise fully justified by the needs of the employer's business, there is no reason why, by an arbitrary rule of thumb, excess of over Rs. 60,000/- per year should be disallowed. One of the reasons far the slow growth of industrial development in India has been the lack of technical and managerial personnel experienced and knowledgeable in special fields and techniques; and unless the corporate sector is in a position to give attractive remuneration, it will not be possible to engage the right type of talent and experience. There are several foreign technicians whose services are vital to our economic growth and they would become much more expensive to the employer if the employer is to be disallowed their remuneration in excess of the arbitrary limit. Besides, the employee himself has to pay his personal taxes at vertiginous rates. To tax him at rates going up to 86% as proposed by the Budget and at the same time to disallow the expenditure to the company, although it is bona fide incurred for business purposes, would be a pure case of double taxation and work most unjustly.

The products of India are; already characterised by such high-cost levels that our exports are shrinking and are bound to shrink still further. The policy of the Government regarding exports has been singularly unimaginative, unrealistic and unprofitable. Every year the cost of our products is pushed further and further by heavier taxation, and at the same time the Government still expects India to gain foreign exchange by increased exports. The general flat increase of 5% on machinery increases the general customs duty on machinery from 15% to 20% (and from 10% to 15% for certain essential machinery). In addition, an overall surcharge of 10% is proposed which would increase the total import duty on machinery to 22% and $16\frac{1}{2}$% respectively. Many companies which have embarked upon projects of expansion or development, have already cast their budgets and they would find it very difficult to meet the increased cost of customs duties, particularly if they work in fields which do not attract private investment. For example, electricity companies establishing new thermal electricity units find that the import of machinery represents more than two-thirds of the total cost of the project. In view of the stringent provisions of the Electricity Act and the unrealistically low return of clear profit allowed under that Act, electricity companies do not attract public investment; and for such companies the recent increase in customs duty on machinery would present a serious financial problem. It may be noted that increase in customs duties results in increase of depreciation and other charges which enter the revenue and expenditure accounts and, therefore, tend to increase the cost of the finished product, resulting in the burden being finally and ultimately passed on to the ordinary citizen.

In short, the Budget proposes to impose an unprecedented and unbearable burden on the nation. One is reminded of the words of the American wit that the difference between the tax collector and the taxidermist is that the taxidermist at least leaves the hide. The time has come to recognise that New Delhi needs not merely a breath of fresh air but a blast of fresh air to sweep away the cobwebs of wrong fiscal thinking.

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

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

—A. D. SHROFF

HAVE YOU JOINED THE FORUM?

The Forum of Free Enterprise is a non-political organisation, started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions, and other means as befit a democratic society.

Membership is open to all who agree with the Manifesto of the Forum. Annual membership fee is Rs. 10/- and Associate Membership fee is Rs. 5/- only. *Bona fide* students can get our booklets and leaflets by becoming Student Associates on payment of Rs. 2/- only.

Write for further particulars (state whether Membership or Student Associateship) to the Secretary, Forum of Free Enterprise, 235, Dr. Dadabhai Naoroji Road, Post Box 48-A, Bombay-1.

Published by M. R. PAI, for Forum of Free Enterprise, "Sohrab House", 235 Dr. Dadabhai Naoroji Road, Bombay 1, and Printed by B. G. DHAWALE at Karnatak Printing Press, Chira Bazar, Bombay 2.

165