THE ECONOMIC IMPLICATIONS OF THE UNION BUDGET FOR 1966-67

By

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

—EUGENE BLACK

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CHANGES RECOMMENDED TO SPUR GROWTH*

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The Union Budget for 1966-67 was presented recently by the Finance Minister as a major instrument for implementing the plans and policies of the Government of India. It is necessary therefore to undertake a short review of the economic developments of the Third Five-Year Plan, which will end this year and assess the success or failure of the Government of India's economic policies during the past five years.

Economic Background

The Third Five-Year Plan had as its primary target a growth in the national income of 6 per cent per year. As against this modest target, national income in real terms rose by 2.2 per cent on an average during the

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first two years of the Third Plan, by 4.5 per cent in the third year (1963-64) and by 7.3 per cent in 1964-65. In the current year, 1965-66, it has been admitted in the latest *Economic Survey* of the Government of India that there is likely to be no increase whatsoever in the national income and that it may actually be lower than in the previous year.

In the field of agricultural production, the record of the Third Plan was erratic and indeed dismal. According to the same Survey the index number of agricultural production moved thus: in 1961-62—144.8; in 1962-63—137.5; in 1963-64—142.6 and in 1964-65—157.6. Total of foodgrains production for 1964-65 was estimated at 88 million tons. But there was a collapse in production during the past year, 1965-66, and the shortfall has been estimated between 10 and 20 million tons as compared with the previous year. The average annual increase in agricultural production during the first four years of the Third Plan worked out to only 2.6 per cent as compared with the growth of 4 per cent per annum achieved during the preceding ten years.

The rate of growth in industrial production, which had nearly reached 11 per cent per annum during the last years of the Second Plan, slumped to an average rate of 7.5 per cent per annum during the first four years of the Third Plan. During the first six months of 1965-66, the rate of growth of industrial production was 7.3 per cent per annum. Then, it slumped precipitately in the last six months of the year to only 5 per cent per annum. Hence the rate of growth of industrial production for the whole year 1965-66 was 6 per cent approximately.

Throughout the Third Plan, the growth of money supply continued. In 1963-64, the growth of money supply was 14 per cent. In 1964-65, it was 9 per cent and during the last year (1965-66) it was 9 per cent. This increasing supply of money was chasing inadequate supplies of goods and commodities with the result that price levels rose continuously. The Government attempted to maintain price stability by following an extremely tight money policy through the banking system during the last two years. But, this policy largely failed to arrest the rise in prices of various essential commodities. On the other hand, the tight money policy initiated by the Reserve Bank caused considerable hardship to trade and industry and adversely effected their growth and expansion.

Prices of both agricultural commodities and manufactured goods rose continuously, with the former registering a much faster rate of rise than those of the latter, thus reflecting the failure of the Government's policy in expanding agricultural output. Over the past year, prices are estimated to have risen by about 8 per cent as compared with the previous year.

Capital Market

The capital market upon which industry depends for the supply of fresh capital has been in ruins. Over the past four years, equity prices have declined at an annual rate of 6.9 per cent. The largest decline took place in the last calendar year and amounted as much as 15.8 per cent. The result of this catastrophic drop in equity prices has been that millions of small and middle class investors who had put their savings in equity shares of various industrial companies suffered a disastrous decline in the value of their investments. The investing public has, therefore, deserted the stock markets of the country.

The new issue market was perhaps the worst hit and shares of new industrial companies slumped to discounts ranging from 50 per cent to 60 per cent of their paid-up values. The investing public was thus mauled so badly that it totally refused to participate in the equity shares offered by new companies during the past two years. Hence new companies could not raise capital from the stock markets and the few of them which made public issues found that their issues had to be almost entirely taken up by the underwriters, who thus increasingly began to perform the function of undertakers.

The balance of payments position of the country remained tight throughout. During the first four years of the Third Plan, the country's foreign exchange reserves (excluding gold) declined by Rs. 70 crores. The balance of payments position remained critical throughout 1965-66. Imports rose from Rs. 1,105 crores in 1960-61 to Rs. 1,396 crores in 1964-65. A large amount of foreign exchange had to be spent in importing foodgrains and fertilizers during the past year. Imports of essential raw materials, spare parts and components for industry and most other items had to be cut to the bone during 1965-66. On the other hand, our exports which had been showing encouraging growth during the first four years of the Third Plan suffered a setback in the last year and this further aggravated the balance of payments crisis. The balance of payments crisis reached a point at which there were strong rumours that the rupee would be devalued. Such a step would have been disastrous for the nation's economy. Fortunately, the Government of India has recently announced that it would not devalue the currency of the country.

The short review of the national economy during the past five years, made in the preceding paragraphs, clearly indicates that we have failed to achieve the targets of the Third Plan. A recent study by the Economic and Scientific Research Foundation, New Delhi, pointed out that the rate of growth of national income in India during the recent years has been the second lowest of all countries in Asia—the lowest place being held by Indonesia. The average annual rate of growth of national income has barely averaged 3 per cent per annum during the Third Plan, which is about half of the target of 6 per cent set by the Planning Commission when formulating the Plan.

Excessive Taxation

Whilst almost all the targets of the Third Plan were not achieved, there was one target in which the performance was more than double the target set in the Plan. The Third Plan target for additional tax measures to be undertaken by the Central Government was Rs. 1,100 crores; but the additional taxation levied by it during this period aggregated no less than Rs. 2,260 crores. This clearly indicates that whereas the targets of growth in national income, in agricultural production, in industrial production, etc. were not achieved, the Government of India recklessly continued to increase the burden of taxation on the citizens of the country. In a large measure the failure of the Third Plan was due to the faulty strategy and technique of developmental planning pursued by the Government of India in the past and its taxation policy was, perhaps, one of the main causes for slowing down the rate of growth of the national economy during the past five years.

This article examines the implications of the budget proposals for 1966-67 in the background of a crisis-ridden economy as outlined above. It analyses what steps should have been taken to get the economy moving forward and what are likely to be the results of the budget proposals introduced by the Finance Minister.

Budgetary Goals

The Finance Minister has frankly recognised the unhealthy trends in Indian economy and stressed the need for remedial action against them. He has expressed sentiments in Part A of his Budget Speech which are most welcome, display an acute realisation of the need for sound policies in economic planning, and outline goals for budgetary policy which are excellent. The Finance Minister said "in many ways, the year that is now drawing to a close has been a very difficult one. Some of the difficulties such as the inadequate performance of the economy, the sluggishness of the capital market, the pressure on the balance of payments and the rise in the prices of essential commodities have been with us now for a number of years; and it is imperative that budgetary and, indeed, all economic policies are framed with a view to reversing these adverse trends." He has stressed that the broad goals of the budget are: to increase the rate of growth of national income by increasing agricultural and industrial production, by maintaining price stability and curbing inflationary pressures in the economy, by increasing exports and thus enabling the flow of the imports on a larger scale of essential raw materials, capital goods and components, by creating a better psychological climate for a greater regard to savings and efficiency all round and by ensuring a more widespread equity participation in the corporate sector by small investors. Unfortunately it would appear that the Finance Minister has failed to take steps in the Budget, which would have enabled these goals to have been attained.

Budgetary Position

The Budget contains proposals for additional taxes, which will yield Rs. 101 crores to the Central Government. It also contains proposals which will enable the State Governments to get more than Rs. 45 crores through additional taxation in a full year. It may be questioned whether in the background of a stagnant or decaying economy, a further dose of additional taxation is justified. The Budget figures show that the yields from customs duties and excise duties have substantially exceeded the budget estimates for 1965-66, but there has been a shortfall in the yields from income-tax and corporation tax. The total revenue surplus for the year 1965-66 which was estimated at Rs. 335 crores is now estimated at Rs. 282 crores. However, after carrying forward the revenue surplus to the capital budget it is revealed that in the place of an estimated overall surplus for the year 1965-66, there will be a deficit of Rs. 165 crores for that year. This deficit is primarily due to the loan assistance to the States extended by the Centre. The Finance Minister has strongly emphasized the weakness of the financial position of the States and the tendency on the part of some of them to resort to unauthorised overdrafts from the Reserve Bank. He has condemned these unhealthy tendencies and has stated that this irresponsible financial behaviour on the part of some States must be curbed in future. Thus, the large overall deficit now revealed in the revised estimates for 1965-66 is primarily due to the reckless, unproductive expenditure incurred by certain States which the Centre was unable to control or discipline.

In the budget 1966-67, the Finance Minister has estimated that, at current levels of taxation, there would be a revenue surplus of Rs. 210 crores. After carrying this revenue surplus to the capital budget, he has revealed that as a result of several planned expenditures, the budget for 1966-67 would have a deficit of Rs. 117 crores at the existing levels of taxation.

Taxes Unjustified

However, this deficit could easily have been converted into a smaller figure or even a small surplus, if the Finance Minister had imposed cuts ranging from 2 per cent to 4 per cent in governmental expenditures during the coming year. Even if that was not possible, it would have been preferable to have left this overall budgetary deficit untouched and even perhaps slightly increased it by cuts in taxes which do not yield large revenues to the Government in order to spur the growth of the economy. If the Finance Minister had reduced the taxes through various measures which he has introduced in the budget and not levied the additional taxation proposed in it, the maximum overall deficit for the year 1966-67 might have been estimated at around Rs. 125 crores. But, then, the economy would have started growing again at a rapid rate, the yields from the various taxes would have outstripped the Finance Minister's estimates; and this, coupled with very minor cuts in public expenditure, especially wasteful and unproductive expenditure, would have converted the estimated overall deficit of about Rs. 125 crores to a much small figure, if not an overall surplus. But the Finance Minister has levied additional taxation in an effort partially to bridge the overall deficit, which step in the current state of the economy is likely to further aggravate the economic problems and cause further deterioration in our economic conditions.

The Finance Minister has proposed, as already stated, additional taxation which is estimated to yield in the coming year Rs. 101 crores to the Central Budget. Of this total, additional excise duties are expected to yield to the Centre Rs. 42 crores and direct taxes on individuals and corporations Rs. 59 crores. This shift in emphasis on direct taxation constitutes a major change in the economic policy of the Government of India. During the past five years, Finance Ministers of the Government of India have stressed that the limits of direct taxation had been reached and that there was no scope for further increases in direct taxation. They had emphasized that in future additional revenues could only be raised primarily through indirect taxation. The budget figures also show that the trend of diminishing returns in the yields from direct taxation has set in. For the first time, in many years, the revised estimates of revenue from personal income-tax and corporation tax has fallen short of the budget estimates. In spite of this, the Finance Minister has adopted direct taxation as the main tool for raising additional revenue. The budget proposals mean that over 58 per cent of the additional taxation will be raised in the form of direct taxes. In the past many years, such a high proportion of additional taxation in the form of direct taxes has never been resorted to by any Finance Minister. Further, throughout the Third Plan, except for the budget following the Chinese attack, direct taxation, estimated to yield a figure of as much as Rs. 59 crores per year, had never been attempted or levied. The shift in emphasis from indirect to direct taxation is a step in the wrong direction.

Excise Duties Inflationary

The economic implications of the various taxation proposals contained in the budget are now analysed.

The Finance Minister has levied excise duties which are estimated to yield over Rs. 52 crores, of which the States' share will be Rs. 10 crores. Hence, the net increase in revenue from excise duties in the Central Budget for 1966-67 is estimated at Rs. 42 crores. The excise duty levied on sugar is estimated to yield around Rs. 22 crores. The Finance Minister has admitted that if the duty is passed on fully to the consumer, the prices of sugar will rise by 8 to 9 paise per kilogramme. The excise duty on cigars and cigarettes and unmanufactured tobacco has been levied to yield an additional Rs. 9 crores. This will push up the prices of cigars and cigarettes. The excise duty on light diesel oil has been increased to yield a revenue of over Rs. 5 crores. This diesel oil is used by thousands of farmers to run their diesel engines and is therefore likely to push up the cost of agricultural production. The excise duties on cotton cloth and yarn have been raised to yield around Rs. 14 crores. This will push up the prices of clothing to the common man. In addition to these major increases in excise duties, the Finance Minister has raised the excise duties on rayon and synthetic yarns, sodium silicate, carbon dioxide, synthetic detergents, optical bleaching agents, etc. which will push up the prices of these goods. The history of the past five years has clearly shown that increases in the excise duties have to be borne by the consumers and push up the prices of various goods and commodities on which such duties have been levied. The result of the increase in excise duties will therefore be to aggravate the inflationary pressures in the Indian economy and push up the cost of living of the common man.

Sales Tax Increased

The Finance Minister has proposed to increase from 2 per cent to 3 per cent the rate of the Central Sales Tax leviable on inter-state sales with effect from 1st July 1966. This change is expected to yield an additional revenue of Rs. 9.5 crores in the year 1966-67 and Rs. 19 crores in the full year 1967-68. These revenues will accrue to the States. Further, it is proposed to raise from 2 per cent to 3 per cent the ceiling prescribed in respect of the sales tax on goods declared to be of special importance in inter-state trade or commerce with effect from 1st July 1966. This will enable the States to raise the sales tax leviable on a wide range of essential goods and commodities and is expected to yield to the States an additional revenue of Rs. 7.5 crores in 1966-67 and an additional revenue in the full year 1967-68 of Rs. 15 crores. These increases in the sales tax levied by the Central Government and if levied by the State Governments will further push up the prices which the common man will have to pay for a large number of essential commodities.

It can be, therefore, concluded that the increase in excise duties and sales tax proposed by the Finance Minister will have a strong inflationary impact on the economy, push up the cost of living of the common man considerably and are, therefore, in direct opposition to the avowed goal of the budget of maintaining price stability and curbing inflation.

Personal Taxation

The Finance Minister has proposed a number of major changes in the direct taxation on individuals and corporations. In the field of direct personal taxation, he has raised the limits of exemption from income-tax of small incomes by Rs. 500. He has also increased by the paltry sum of Rs. 25 the various personal allowances allowed for income-tax purposes to individuals. These changes are estimated to result in a loss in revenue of Rs. 3.5 crores. The Finance Minister has claimed that he has introduced these changes to provide a measure of relief to poor tax payers, but he has admitted that "these measures will also accelerate the performance of the task of the tax authorities by eliminating a large number of assessments and thereby enabling them to devote more and swift attention to tax collections from higher incomes." These minor reliefs are undoubtedly welcome.

The beneficial effects of these minor concessions have been more than offset by the massive increase in personal income-tax proposed by the Finance Minister. The budget proposes the levy of a flat special surcharge of 10 per cent of the amount of income-tax and surcharge on earned income and unearned incomes payable by individuals and registered firms. This change alone is expected to yield and additional revenue of Rs. 25.6 crores. The net result of these changes in the taxation of personal incomes can be analysed as follows: First, individuals with incomes up to Rs. 7,400 per year will pay slightly less by way of income-tax and surcharge. Second, the burden of income-tax on assessees with incomes of over Rs. 7,400 per year is substantially increased and the burden of income-tax as compared with that of the previous year increases progressively with increases in the taxable income. Third, the highest marginal rate of income-tax and annuity deposit payable by individuals has now risen to 84 per cent on earned incomes and over 90 per cent in the case of unearned incomes. Fourth, the budget for 1965-66 estimated an yield from personal income-tax at Rs. 291.50 crores but the revised estimates for the year show that it is likely to be only Rs. 260 crores. The yield from taxes on income at current levels of taxation for the budget for 1966-67 is estimated at Rs. 270 crores and the Finance Minister has placed the net income in the additional income-tax at over Rs. 24 crores, as a result of the budget proposals. The implications of these changes are that personal incomes which appear to have fallen during the past year, as indicated by the shortfall in the revenue yield now estimated for the year 1965-66, will be further squeezed by an additional impost of over Rs. 24 crores. This sum will, therefore, result in a transfer of Rs. 24 crores from the pockets of individuals to the Exchequer. In the absence of additional taxation this amount could have been saved by individuals and invested in productive enterprises in the private sector. At least a substantial part of it would have flowed into the stock markets. The levy of the additional income-tax on individuals will, therefore, reduce personal savings and investments, retard the growth of the private sector and hamper the revival of the capital market.

Unit Trust Encouraged

The Finance Minister has given a slight concession to encourage the individuals to invest in the Unit Trust of India by providing that in future an income up to Rs. 1,000 from dividends of the Unit Trust of India will be excluded from the total income of all assesses from income-tax purposes. This very minor relief may stimulate some investment in the Unit Trust of India, but it is not likely that it will result in a large flow of private savings into that institution, and through it into the stock markets.

Minor Relief in Annuity Deposits

The Finance Minister has proposed to raise the exemption limit of annual income for annuity deposits from Rs. 15,000 to Rs. 25,000 This change will apply in the case of salaried assessees for the assessment year 1966-67 and in the case of non-salaried assessees for the assessment year 1967-68. However, it should be noted that those assessees with incomes between Rs. 15,000 and Rs. 25,000 who do not make the annuity deposits will have to pay a larger amount by way of income-tax. Therefore, the Finance Minister has provided that such assessees may voluntarily continue in the Annuity Deposit Scheme. The Finance Minister has realised that this scheme involves a tremendous amount of administrative work and he has admitted that he has raised the exemption limits in order to reduce the number of people required to make annuity deposits from the present figure of 1,76,000 to 80,000. The short term loss in respect of annuity deposits as a result of this change is estimated at Rs. 7 crores, after taking into account the corresponding gain of income-tax of Rs. 2.42

crores. It has also been provided that persons on attaining the age of 70 years can opt out of the scheme.

These minor modifications in the Annuity Deposit Scheme fail to provide any sizeable relief to the harassed tax payers of this country. Even after these changes are effected, it is estimated that the Annuity Deposit Scheme will drain away Rs. 35 crores annually from individuals into the Exchequer. Further, the Scheme will continue to impose tremendous administrative burdens on the Government and cause a fantastic amount of harassment to the assessees. If the Finance Minister wants to mop up Rs. 35 crores in the short run per year, it would have been better done by abolishing the Annuity Deposit Scheme and providing that individuals at present subject to the Scheme will be compulsorily required to buy Government Securities of an amount equal to that payable under the Annuity Deposit Scheme. The continuation of the Annuity Deposit Scheme means that personal savings of over Rs. 35 crores per year are appropriated in the short run by the Government of India and are, therefore, diverted from the avenues of productive private investment.

Expenditure Tax

The Finance Minister has abolished the Expenditure Tax. This unsound tax was first introduced by the former Finance Minister, Mr. T. T. Krishnamachari, in 1957. It was abolished thereafter by his successor, Mr. Morarji Desai, and reintroduced two years ago by Mr. T. T. Krishnamachari, when he regained the Finance portfolio.

It was a thoroughly unsound, impractical and economically indefensible tax. When the tax was first introduced, I had pointed out in various articles and monographs that it would fail to yield any sizeable revenue and I had predicted that the cost of collection of this tax would probably exceed the revenue therefrom. I had continued to stress this point in succeeding years when the tax was levied.

Years of experimentation with this unsound tax have now conclusively proved that its introduction was a colossal mistake. During the years when the tax was levied, it failed to raise revenue of even Rs. 1 crore in any year. The present Finance Minister has now admitted frankly that he proposes to abolish the Expenditure Tax for administrative reasons. He has stated in his Budget Speech that "the yield from this tax is very little, namely, Rs. 60 lakhs or thereabouts, which has not been commensurate with the burden it puts on the administration." The Finance Minister is to be congratulated for having realised that the claims of Mr. Nicholas Kaldor and other impractical economists, who in the past had advocated this tax, have been proved false and incorrect.

Gift Tax Reduced

The Finance Minister has recognised the need for rationalising the structure of the gift tax and reducing its rates. The gift tax was originally introduced on the justification that it would prevent evasion of estate duty by individuals through giving away their wealth as gifts. However, over the years, its rates were raised to levels which exceeded those of the estate duty and its structure had become administratively cumbersome. Under the budget proposals, the exemption limit for gifts not liable to gift tax has been raised from Rs. 5,000 to Rs. 10,000 per year. Under the existing law, it was provided that gifts to the same donee made during the previous four years had to be aggregated for the purposes of arriving at the rate of the gift tax. The Finance Minister has recognised that this very cumbersome provision was impractical and stated that "it is a measure whose practical utility is not established, specially if the time and trouble it involves on the part of both the administration and the assessees are taken into account." He has, therefore, abolished this provision. This is a step in the right direction, towards simplifying the administration of the taxation along practical lines.

The budget proposals provide for the lowering of rates of gift tax on all slabs upto Rs. 15 lakhs. This is done in recognition of the fact that the rates of gift tax in the past were excessive. The total yield in revenue from the gift tax at the existing levels was estimated at Rs. 3 crores for the coming year. The changes introduced in the budget are estimated to result in a reduction in the revenue from gift tax to Rs. 1.71 crores in the coming year.

Estate Duty Raised

The Finance Minister has raised the rates of estate duty on the lower slabs. Thus, on the slab of Rs. 1 to Rs. 2 lakhs the rate has been raised from 8 per cent to

10 per cent; on the slab from Rs. 3½ to Rs. 5 lakhs, the rate has been raised from 15 per cent to 25 per cent; and, in the slab from Rs. 5 to Rs. 10 lakhs, the rate has been raised from 25 per cent to 30 per cent. These are extremely stiff increases in the rates of estate duty, which will fall upon small estates and will cause considerable hardship to the middle classes. The rates of estate duty in India were already excessive and there is no justification for increasing them now, especially on small estates. The Finance Minister has also provided that gifts made within two years of death will be treated as a part of the estate for the purposes of the estate duty, whereas the present law provided for the inclusion within the taxable estate of gifts made only within a year of the death. This change will enhance the burden of estate duty. A minor change has been made to provide that policemen and members of the security forces killed in the defence of the country will be exempt from the provisions of the Estate Duty Act. The result of these changes in the estate duty will be that against an estimated yield of Rs. 7.40 crores for the coming year, the estate duty will yield the additional Rs. 70 lakhs.

Rates Inconsistent

It is interesting to make a comparison between the rates of gift tax and estate duty, since the gift tax is justified on the grounds of preventing evasion of estate duty. Logically speaking, the rates of both these taxes should be identical, but, as a result of the changes proposed in the budget, a curious pattern emerges. Upto slabs of Rs. 5 lakhs, the rates of estate duty are lower than those of the gift tax. In the slabs of Rs. 5 to Rs. 20 lakhs, the rates of estate duty and the gift tax are identical. In the slabs beyond Rs. 20 lakhs, the rate of estate duty is greater than that of the gift tax. It is difficult to understand why such an inconsistent pattern of the rates of these taxes has been adopted. There was an urgent need to synchronize the rates of these taxes and to substantially lower them so as to reduce their burden and to increase the quantum of savings available for investment in the private sector. The Finance Minister has failed to give any significant relief in these vital areas of taxation.

The overall result of the changes in personal taxation outlined above will be to drain away the savings of over Rs. 20 crores of individuals into the public exchequer. These savings would in all probability have been invested in productive enterprises and would have contributed to the economic development of the country. The chances are that their transfer to the public exchequer will result in their being frittered away in wasteful and unproductive expenditure which will be a loss to the nation.

Corporate Taxation

The Finance Minister has proposed a sizeable increase in the basic rate of income-tax payable by companies. He has increased these rates by 5 per cent of the total taxable income, which works out to an average increase in taxation of about 11 per cent as compared with the existing levels of taxation. The profits of life insurance business will be taxed at a rate which will rise from

47.5 per cent to 52.5 per cent. This will adversely affect the net profits of Life Insurance Corporation of India and in turn millions of policy holders, who hold life policies with profits.

In the case of public companies, with profits of less than Rs. 25,000 the rate of income-tax is to be raised from 42.5 per cent to 45 per cent of their taxable income. Such public companies are few. In the case of public companies with profits of more than Rs. 25,000 the rate of income-tax is to be raised from 50 per cent to 55 per cent of their taxable income. A very large number of public companies will thus be affected. In the case of closely held companies, the rate of tax on the first Rs. 10 lakhs of industrial profits is to be raised from 50 per cent to 55 per cent and the rate of tax on the remaining income is to be raised from 60 per cent to 65 per cent of the taxable income. In the case of foreign companies, the rate of income-tax is to be raised from 65 per cent to 70 per cent, with the proviso that the rate of tax on royalties will remain at 50 per cent. There is a special provision that income arising from the supply of "know-how" to foreign companies by Indian companies will be taxed at the rate of only 25 per cent. But this concession is likely to benefit very few companies.

This increase in the basic rates of income-tax on corporate profit is expected to yield an additional revenue of Rs. 49 crores. The burden will be felt by all companies. The result of these changes will be that the rates of corporate taxation applicable in India will undoubtedly be the highest in the world and far in excess of those prevailing in other developing countries.

Priority Industries

Under the existing tax laws, certain priority industries were entitled to a rebate of 10 per cent of the income-tax and 20 per cent of the surtax payable by them. However, the mode of computing their taxable income was very cumbersome administratively, because it involved the giving of rebates at various rates under various conditions. To simplify the administration of taxation, the Finance Minister has provided that in the case of priority industries, they will be allowed a straight deduction of 8 per cent of their total income in computing their taxable income for purposes of income-tax and surtax. This step in the simplification of taxation is welcome. It will maintain the tax differential between the priority and non-priority industries. However, it must be emphasized that the priority industries will be hit by the general increase in the basic rates of corporate taxation.

The list of priority industries has been expanded to include the tea, newsprint and printing machinery, which will give much encouragement to these industries.

Surtax

Years ago when the Super Profits Tax and thereafter the Surtax were levied, various economists including myself had suggested that, in place of these taxes, it would be preferable to have an increase in the basic rate of income-tax levied on the corporate sector, to yield the same revenue as was sought to be raised from these taxes. The Super Profits Tax was abolished, and, in its place, the Surtax was introduced. Unfortunately, in the latest budget the Finance Minister has increased the basic rates of income-tax levied on the corporate sector, but has failed to abolish the Surtax. He has only proposed a minor reduction in the burden of Surtax by reducing the rate of Surtax from 40 per cent to 35 per cent. This concession is expected to result in a loss of revenue of around Rs. 2.5 crores. The total revenue from the Surtax is estimated at around Rs. 16 crores per year. Since the Finance Minister has raised the basic rates of income-tax on companies to yield no less than Rs. 49 crores, it was imperative that the Surtax should have been abolished.

Moreover, the basic rates of income-tax applicable to companies will affect all companies whereas the surtax was and will be paid by only a very small number of companies with high rates of profits. The token reduction in the rates of Surtax will, therefore, benefit only a minute proportion of the corporate sector.

Dividend Tax

Under the provisions of the Finance Act, 1965, companies had to pay a dividend tax at the rate of 7.5 per cent on dividends declared on the equity shares. The tax was not payable by companies on dividends paid on their preference shares, or by companies which had to compulsorily distribute dividends under the provisions governing closely held companies, or by new companies declaring dividends up to 10 per cent of their equity capital during their first five years. The Finance Minister has recognised that the holders of equity shares in all companies are entitled to a normal dividend of at least 10 per cent on the paid-up value of their shares in the present tight money conditions, without the companies having to pay this penal dividend tax. He has, accordingly reduced the burden of the dividend tax, by providing in the budget that dividends up to 10 per cent of the paid-up value of equity shares will be exempt from the dividends tax. This is a step in the right direction. The loss in revenue as a result of this change is estimated at Rs. 4.8 crores. However, in view of the increase in the basic rates of corporate taxation proposed in the budget, the Finance Minister should have totally abolished the dividend tax.

Tax Burden Raised

The economic implications of the changes in the basic rates of corporate taxation, the reduction in the rate of Surtax, and the reduction of the burden of the dividend tax as outlined above, can be clearly analysed. The following effects of these changes will occur: First, the vast majority of companies in the corporate sector, perhaps more than 90 per cent of the companies, will pay more taxes as a result of the budget proposals than they would have done under the existing tax laws. Second, a few companies which were paying very high Surtax and dividend tax will be less effected by these changes than other companies which were not paying surtax or the dividend tax. Third, the burden of direct taxation on the corporate sector will increase substantially and will result in one of the two alternate repercussions. As a result of the reduction in the net profits due to the increase in the burden of taxation, companies will either have to cut their dividends or plough back lesser amounts to reserves for financing their expansion, given the same level of profits.

Cash Flow to Shareholders Slashed

The budget proposals will also reduce the rate of cash flow from dividends accruing in the hands of shareholders because of the proposed increases in the rate of deduction of income-tax at source. The Finance Minister has proposed that the rate of deduction of tax at source on dividends paid to individuals by companies be increased from 20 per cent to 22 per cent, and the rate of deduction at source on dividends paid to foreigners will rise from 30 per cent to 33 per cent.

Moreover, it has also been provided in the case of preference shares which were issued subject to deduction of the companies' income-tax that the deduction on this count be increased from 25 per cent to 27.5 per cent. These changes will reduce the cash received by shareholders in the form of dividend payments.

Bonus Tax Abolished

The Finance Minister is to be heartily congratulated for having recognised the injustice of taxation of bonus shares issued by companies. During the past two years, shareholders who received bonus shares from companies on capitalisation of free reserves (excluding the share premium account reserves), had to pay the Capital Gains Tax on a notional basis according to the market value of the bonus shares as on the 31st day after the date of their allotment. This was an extremely harsh measure which resulted in the total abandonment of the issue of the bonus shares from free reserves by companies during the past two years. The Finance Minister has correctly abolished this provision of the notional taxation of bonus shares in the hands of shareholders, and he has frankly admitted that the loss in revenue from this change is negligible: this is estimated at around Rs. 7 lakhs, even which figure appears to me to be on the high side. It is now provided that shareholders will pay the capital gains tax on bonus shares only when they sell such shares and make a profit thereon. This change will remove the main impediment to companies issuing bonus shares out of their free reserves in the coming year.

The Finance Minister has also proposed that the tax payable by companies at the rate of 12½ per cent on the face value of bonus shares issued by them on capitalisation of their free reserves will be abolished. It might be noted that this change comes after more than a decade during which companies were required to pay tax at the rate of 12½ per cent and, in some years at much higher rates on the face value of bonus shares issued by them. The loss in revenue as a result of this concession is estimated at Rs. 9 lakhs.

Psychological Irritant Removed

The total abolition of the taxation on bonus shares has removed a great psychological irritant to the healthy working of the corporate sector. For the past ten years, various economists and tax authorities, including myself, have been pointing out that the issue of bonus shares for capitalising the free reserves of companies was necessary to rationalise the capital structure of companies and to bring the paid-up capital more in line with total capital invested in the business. Now that the Finance Minister has conceded the validity of these arguments, it is necessary that industrialists and corporate managements should take full and proper advantage of these concessions and should capitalise the free reserves of companies to the maximum extent permissible under the rules used by the Controller of Capital Issues.

The Controller of Capital Issues generally requires that, after capitalisation of reserves by the issue of bonus shares, the free reserves of a company should at least amount to 20 per cent of the increased capital thereof. Conservative managements may adopt the slightly higher ratio and may keep the amount of free reserves at, say, 30 per cent or 40 per cent of the increased capital after issue of bonus shares. But there will be no justification for corporate managements to capitalise their reserves on a small scale by issuing bonus shares in very conservative ratios.

Fresh Approach Required

The bonus shares announced in the past few days after the budget have been on a scale which is very small and which indicates that corporate managements are approaching the problem in an old-fashioned, conservative and unrealistic fashion.

Corporate managements must realise that it has taken ten years of severe struggle and persuasion to have the taxes on bonus shares removed altogether. They should also appreciate that, in our country, there is always the danger that the taxation on bonus shares may be reintroduced in another year or two for revenue considerations. The tax on bonus shares at the rate of 12½ per cent of their face value levied on companies used to yield by itself crores of rupees in revenue when the notional taxation of bonus shares in the hands of shareholders was absent.

Corporate managements should, therefore, seize the golden opportunity given by this budget to once and for all capitalise the reserves of their companies to the fullest possible extent, working on the assumption that, perhaps, this may be their last chance to do so for many years to come. Corporate managements should not approach the problem of issuing bonus shares with the same attitude with which they tackled this issue in the years before 1955. In those days, they were justified in issuing bonus shares on a modest or small scale in a particular year because they could look forward to repeating the operation over the years. There is no justification for believing that the opportunity for issuing bonus shares without paying taxes will continue in India during the years to come and therefore to try and stagger out the issue of bonus shares for capitalisation of reserves over a period of time. Corporate managements who fail to capitalise their reserves fully by the issue of bonus shares to the maximum extent possible during this year may miss an unique opportunity of once and for all rationalising the capital structures of their companies.

It has been argued by some corporate managements that, in view of the increased burden of direct taxation on the profits of companies, they should issue bonus shares for capitalisation of their reserves on a very small or modest scale, which will enable them to maintain the dividends on the increased capital. This notion is fallacious and indicates that managements continue to apply the principles of corporate finance of the pre-1955 era which should not be applied now when our political and fiscal climate is so uncertain. When the industrialists, economists and tax experts were urging the Government to abolish the taxation on bonus issues, it was never done on the ground that the issue of bonus shares would provide a pretext to increase the total profits of companies distributed by way of dividends to the shareholders. The issue of bonus shares for capitalisation of reserves was urged as being necessary to bring the paid-up capital of the companies in line with the total capital invested in the business. Now that the chance is available to do this, it should be taken advantage of fully ; and corporate managements should not be inhibited by their inability to maintain the dividends on their shares after the bonus issues are made. On the contrary, they should capitalise their reserves to the fullest extent by issuing of bonus shares and clearly indicate to the shareholders that dividends on the increased capital in the years to come will depend entirely upon the net distributable profits as earned by the companies in the future.

Tax Advantage of Bonus Issues

In the case of companies which are paying dividends in excess of 10 per cent of their paid-up capital, the issue of bonus shares offers an immediate tax advantage in so far as the liability to dividend tax will be reduced by the issue of bonus shares. For example, if the company is paying dividends on its equity shares at the rate of 30 per cent, then it will have to pay dividend tax on the dividend amounting up to 20 per cent of the paid-up value of their shares. But if such a company issues bonus shares then, the dividends as percentage of the paid-up capital will be reduced even if the total distribution of profits is maintained and since the first 10 per cent equity dividend will be exempt from dividend tax, the burden thereof will be reduced. Indeed, if such a company issues two bonus shares to its shareholders for every share held and then reduces the dividend on the increased capital to 10 per cent, the income of the shareholders will remain the same but the company will be totally exempt from the dividend tax. Thus, there is the strongest economic justification for companies to issue bonus shares to the extent that after capitalisation of their profits by the issue of such shares, their dividend on the equity capital is reduced to 10 per cent of the paid-up value of their equity shares or slightly more than that figure.

Capital Market Not Revived

The mere issue of bonus shares will not revive the capital market in the long run. The revival of the capital market depends upon the profitability of companies after paying their direct taxes and the dividends distributed by them. The issue of bonus shares is a mere paper transaction to rationalise the capital structures of companies and does not confer any economic benefit upon the shareholders. The prices of shares will depend upon the dividends paid in future and, as mentioned earlier, the budget proposals are likely to cripple the dividend paying capacity of many a company.

Development Rebate Concessions

The Finance Minister has offered some minor concessions in the development rebate allowed on new plant and machinery. Tea, newsprint and printing machinery have been put in the list of priority industries, which will get development rebate at the rate of 35 per cent on the value of plant and machinery installed by them after 1st April 1966. In the case of the shipping industry, it is provided that only 50 per cent of the development rebate instead of the usual 75 per cent thereof, will be required to be debited to the profit and loss account. In view of the great increase in the burden of direct taxation on companies, such a concession should have been given to all industries. It has also been provided that the development rebate will not be lost in the case of foreign subsidiary companies merging into their foreign parent companies. The development allowance for the tea industry has been raised and its deduction is now to be allowed in stages. These minor concessions are welcome.

Financial Institutions

Financial institutions with a capital of less than Rs. 3 crores which provide long-term finance for industry are to be given the concession of deducting up to 25 per cent of their total income put to special reserves in computing their taxable income for income-tax purposes. The rate of deduction for the larger financial institutions with capital of more than Rs. 3 crores will, however, continue at 10 per cent of their total income as hitherto.

Depreciation

The Government has realised that the rate of depreciation of Indian industries is inadequate and does not allow for modernisation and the rapid write off of their plants and machinery which are so essential to keep technologically abreast of changing developments in a rapidly progressing world. The Finance Minister said in his Budget speech that "the rate schedule of depreciation allowable in respect of buildings, furniture, plant, machinery, etc., has become highly complicated. It is necessary to review the position in the light of recent developments and to make appropriate changes so that the schedule may be both rational and simple. I propose, therefore, to initiate a complete review during the next few months." It is hoped that this review will increase substantially the rates of depreciation allowed on assets to corporate and non-corporate assessees. Instead of having a large number of different rates as at present for different types of assets, it would be desirable completely to simplify the rate schedule by providing a flat rate of depreciation of 20 per cent on the value of all assets used by assessees in their business. An additional allowance of a similar amount may be given for extra shifts worked by various industries.

The Finance Minister should also consider the idea of allowing depreciation to be given as a deduction in computing the taxable income from property which is not used for business purposes. Today, no allowance is given for depreciation on buildings which are rented out, with the result that the landlords of such buildings are unable to replace them when their useful life expires and they collapse or have to be broken down. It should be provided that depreciation at the rate of 3 per cent will be allowed on buildings built in the last 10 years, at the rate of 5 per cent on buildings which are between 10 and 30 years old and at the rate of 10 per cent on buildings which are more than 30 years old. Depreciation at these rates can be allowed on the book value of such buildings or their current market value or the values at which they are insured as on 1st January 1966.

Some Minor Concessions

The Finance Minister has made a small start in liberalising the depreciation allowances by providing that initial depreciation of 20 per cent on the cost of new buildings erected by employers and used by employees can be given where employees using such buildings draw up to Rs. 7,500 per annum, in the place of present limit of Rs. 2,400 per annum.

It has also been provided that the cost of small items of plant and machinery costing not more than Rs. 750 per unit may be allowed to be depreciated in any one year. But this concession is impractical, because there is hardly any item of plant and machinery which costs only Rs. 750 in today's times. The limit of Rs. 750 should be raised to, say, Rs. 10,000. It is proposed in the budget that depreciation on cars which cost more than Rs. 25,000 will be allowed only as if they had cost Rs. 25,000. This is a measure which is placed to curb ostantatious consumption and is a minor change. The budget also provides for minor changes in the procedure in writing off patents and copyrights, which constitute token concessions.

The Finance Minister has introduced a number of small changes in the definition and taxation of closely held companies. It is proposed that for such of them as are mainly engaged in manufacturing activities or in shipbuilding, the test of the public being substantially interested will be satisfied if 40 per cent of the equity is held by the Government, public corporations or members of the public, etc., instead of 50 per cent as at present. Second, companies mainly engaged in shipbuilding will not be compelled to distribute their profits up to the statutory percentages. Companies partly engaged in manufacturing activities will also not be required to make a compulsory distribution of their profits relating to such activities. Finally, certain types of expenses incurred by closely held companies, which are disallowed for the purposes of determining their tax liability, will be allowed as a deduction in computing the distributable profits on such companies in future.

Corporate Sector Mauled and Crippled

The net result of changes in corporate taxation can now be analysed. It would appear that the profits of the corporate sector for the year 1965-66 declined sharply because the yield from the corporate taxation, which was estimated in the budget for 1965-66 at Rs. 371 crores, is expected now under the revised estimates to yield only Rs. 330 crores. At current levels of taxation, the yield from the corporate taxation for the coming year under the budget for 1966-67 is estimated at Rs. 340 crores. The Finance Minister has estimated that as a result of the changes proposed in the budget, he will realise an additional sum of Rs. 36 crores from corporate taxation. Thus, the burden of direct taxes on corporations is expected to increase by around 11 per cent if corporate profits remain the same as in the past year. Hence the following effects will occur in the corporate sector:

First, the net profits of the corporate sector after taxation, will be reduced by Rs. 36 crores as a result of the additional taxes imposed in the budget.

This blow coming at a time when the profitability of the corporate sector has been falling will be very difficult to bear. Second, the increased burden of direct taxes on the corporate sector will mean that the profits distributed by way of dividends will have to be reduced or, alternatively, the amounts ploughed back to reserves for expansion and growth will be reduced. Third, the expansion and growth of the corporate sector will be adversely affected because the budget will take away over Rs. 36 crores from the resources of this sector, which money should have been used for its expansion and growth. Fourth, the capital market will not revive because the additional burden of direct taxation placed on the corporate sector will cripple its dividend paying capacity. Even in the case of companies, where there has been a growth in profits, the additional taxation will probably neutralise the financial benefits of such growth. Fifth, the new issue market will continue to remain completely dead and investors will not subscribe to shares of even first class new industrial companies, because the outlook for the corporate sector remains bleak. Over the years, the corporate sector has become the favourite whipping boy of successive Finance Ministers who have continuously increased the direct taxes on companies. Investors will feel that it is better to invest their savings in other avenues of investments which are not so heavily taxed as the corporate sector.

Finally, foreign private investment will not flow into the country because of these excessive rates of direct taxation levied on companies. The recent statement of the Finance Secretary that foreign investors were only interested in their gross profits and do not care for taxes is unrealistic. Foreign investors are always concerned with the net profits after making all provisions and paying taxes, which they can make by investing in any country. The net returns from investment in corporate enterprises in India have become extremely unattractive as a result of the structure of direct taxation and the flow of foreign private capital into India will diminish further if not dry up totally in the coming years.

Charitable Trusts

The Finance Minister has made a change in the taxation of charitable trusts or institutions which is likely to have most inequitable and harsh effects on these trusts and institutions. The Income Tax Act, as it now stands, provides that in the case of a charitable trust or institution established after 31st March 1962, the income from the property held by it will not be entitled to exemption from tax, if, under the terms of the trust or the rules governing the institution, any part of such income goes directly or indirectly for the benefit of the author of the trust or founder of the institution or the relative of any such person. It is proposed to extend this provision for denial of the exemption even to cases where, under the terms of the trust or the rule governing the institution, any part of such income ensues directly or indirectly for the benefit of any person who has made a substantial contribution to such trust or institution or the relative of any such person. It is also proposed to extend this provision to cases where any part of the income or property referred to above, is, during the previous year, used or applied directly or indirectly for the benefit of the author of the trust or founder of the institution or any person who has made a substantial contribution to such trust or institution or any relative of such author, founder or person. Since these changes will apply retrospectively, i.e. from the financial year ended 31st March 1966, many charitable trusts or institutions may suddenly find themselves paying income-tax merely because they may have given assistance in the past year to genuinely poor relatives of the categories of persons mentioned above, connected with such trusts or institutions. If this change is to be made, it should only apply with effect from 1st April 1966. It is an inequitable change in so far as it permanently prevents genuinely poor relatives of those who give to charity from receiving any benefits from the charitable institutions and trusts. There is no justification for penalising the relatives of those who act philanthropically and give away their wealth to charity. It should be provided that if the charity trust or institutions give any part of their income to the relatives of their founders or contributors, they will lose the exemption from income-tax only if it is found that such recipients were not genuinely deserving or poor or, say, if they had an income of over Rs. 1,800 per year.

Conclusion

The Finance Minister was appointed only a few weeks before the Budget. He inherited the legacy of the wrong economic policies followed by the Government of India during the Third Plan, which had caused havoc and ruin to the economy. He, therefore, faced a very difficult task in framing the budget and must be congratulated for his efforts to streamline and simplify the administration of taxation and remove many taxes which were imposed in the past on illogical and ideological grounds, but which failed to yield any revenue and marred the psychological climate for growth and investment in the economy. It is to be hoped that before the Finance Bill is passed into law, he will reconsider his taxation proposals and give further reliefs on the lines suggested above, so as to spur the growth of the Indian economy and lead the nation to progress and prosperity. To do this, he must discard following the economic theories of planning and budgetary performance, which have been discarded by many other nations and which we have hitherto attempted to follow with disastrous results under the Third Plan.

The views expressed in this booklet are not necessarily 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

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