THE UNION BUDGET, 1971-72

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

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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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By

N. A. PALKHIVALA

The pride of place in the Parliamentary Calendar still belongs to the annual ritual of the Budget. The fiscal measures adopted by a government constitute perhaps the most significant aspect of its economic policy; and the economic policy pursued by a government is the single most important factor in the economic development of a nation. Abundance or scarcity of natural resources, rate of population growth, the level of education and geographical conditions, have a strong impact on the economic environment; but more crucial than them all is the economic policy.

The Government of India, with its tremendous political mandate, had a golden opportunity of bringing in a nutritive Budget which could have harnessed to great national purposes the immeasurable reservoir of the people's faith and response, energy and enterprise. But instead, it has introduced a Budget which will sap the nation's strength, blight confidence and strangle enterprise. Whereas the Budget could have given the patient 547 millions the chance of a brighter tomorrow, it only aims at ushering in a socialist springtime of dead flowers.

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* This text is based on a public lecture delivered under the auspices of the Forum of Free Enterprise in Bombay on 5th June, 1971. The author, eminent authority on taxation and constitutional law, is the President of the Forum of Free Enterprise.

The first Indian Budget in modern form, containing the first levy of income-tax, was presented to the Legislative Council on 18th February 1860 by the first Indian Finance Member, James Wilson, who said in his Financial Statement of that year, "The normal state of Indian finance may be said to be deficiency of income and addition to debt". In that Budget the rate of income-tax was 2% upon incomes between Rs. 200 and Rs. 500 a year, and 4% on incomes above Rs. 500. The maximum rate of 4% was reduced in 1863 to 3%, and in 1869 to 1%. The wheel has now turned full circle. Instead of the assessee paying 2% tax and keeping 98% of his income, he has now to pay 98% tax and keep 2% of his income.

More than any other Budget during the last 111 years, this year's Budget is in its conception ideology-oriented, and in effect will prove poverty-oriented. The philosophy underlying the Budget rests on the following inarticulate major premises:

(1) It is enough, and a lot easier, to impoverish the rich instead of enriching the poor. **"Amiri hatao"** at Budget time is an excellent political substitute for **"Garibi hatao"** at election time: and the public mind may be trusted to be sufficiently muddled to see no distinction between the two.

(2) The laws of human nature should be treated as impliedly and effectively repealed by the laws of Parliament.

(3) A citizen of integrity and intellect, industry and enterprise, does not deserve to keep even a reason-

able part of the fruits of his own labours. It is politically expedient to have a ceiling on income, although in practice it merely amounts to a ceiling on honesty.

(4) The private corporate sector needs no incentives. It should find its deepest satisfaction in the fact that while, as a result of manifold restrictions on initiation and expansion of industry, it is permitted to contribute only 8% of the total national income (as against 70% in developed countries), it contributes no less than 60% of the direct and indirect taxes collected by the Central Government.

(5) The agricultural sector is politically too important to be taxed even reasonably; mounting savage taxation should be discreetly reserved for urban citizens who have no political lobby worth the name.

Impoverishing talent and enterprise is a political gimmick; eradication of poverty would be an economic achievement. You do not really need the very expensive outfit of a vast Finance Ministry to manage the former; an intelligent school boy can think up the simple expedient of imposing staggering rates of income-tax and wealth-tax. On the other hand, eradication of poverty demands wisdom and knowledge, character and dedication, of the highest order; and only the finest of governments achieve it, though all political parties adopt it as their slogan.

The Budget will, no doubt, have the effect of reducing the disparity between the honest rich and the poor. But this object will be achieved at the cost of vastly increasing the number of black-marketeers, tax-evaders and licence-peddlers. We may continue to dream of a higher standard of living for the masses, but will never manage to underwrite our dream in terms of output. Neither the gross national product nor the *per capita* income will increase. But by constricting growth and aggravating inflation, the Budget will definitely increase poverty. There will be a sharp rise in the army of the unemployed who already number 20 million on a reasonable estimate. With this year's Budget one can confidently predict that the estimate of 28 million desperate job-seekers at the end of the Fourth Plan will be substantially exceeded by the actual figures. Any Budget which on ideological grounds prevents the full development of job potential constitutes a crime against the nation.

The problem of conquering poverty is not insoluble. Thus, when the World Bank appointed the Lester Pearson Commission to study the achievements of developing countries, and the role that foreign aid could play, it came to the striking conclusion that of the 69 developing countries whose growth-performance was assessed, as many as 32 scored during the first 7 years of the 1960s an annual growth rate of over 5%; and 19 of these 32 countries scored an annual growth rate of over 6%. Regrettably, during the same period, India's growth rate hovered around 3.2%. In fact, India was in the same boat as Burma, Congo, Haiti, Mali and Somalia. It is true that in the last 3 years, there has been a heartening improvement in the performance of agriculture, but even after taking this into account, the annual average growth rate for the decade as a whole is no more than 3.6%, which set against the annual population growth rate of 2.45%, leaves a negligible increase *per capita.* It is an irony worth contemplating that the two richest countries of Asia, viz. Japan and Singapore, are also countries without any natural resources. Here with all our wealth of natural resources we struggle with an annual *per capita* income of $90, against $800 of Singapore and $2,100 of Japan.

It is a truism which will bear repetition that in economics there are no miracles; there are only consequences. The only way of eradicating poverty,—of translating **"Garibi hatao"** into action—is to work more, save more, invest more. But this year's Budget offers the strongest possible disincentives to work, to save or to invest. The most expensive hobby of Indians is work. Capital formation is at the miserably low rate of 12% of the national income; and the Budget will ensure that the 15% rate of saving targeted in the Fourth Plan will not be achieved. The powerful disincentives to saving are the steady erosion in the value of the rupee and the vertiginous levels of wealth-tax and income-tax.

When the basic instincts of human nature and the deep-grained motivations of human conduct come into sharp conflict with man-made laws, it is the laws which are invariably defeated and brought into contempt. Yet in the Budget Speech year after year our Government gives expression to the juvenile delusion that new laws and more laws are all that is needed to make men work mainly,—and at a certain level, wholly—for the benefit of the Exchequer.

It is a sad reflection on human nature, but a fact of life which we ignore only at our peril, that a man will work for himself and for his family as he will work for no one else. Our laws fight a losing battle with the acquisitive instinct of man. In Russia and other communist countries, taxi drivers will surreptitiously ask for foreign exchange from complete strangers, although the death penalty is the punishment for such an act. Wise governments reasonably regulate these normal human instincts and ensure that they create open wealth for the nation. Foolish governments permit these instincts to create black-markets and black money.

The proposal for levying income-tax at rates going up to 97.75% and wealth-tax at rates going up to 8% (plus 7% in the case of urban property) virtually amounts to annual confiscation of income and wealth. These proposals make it clear that the Government is determined to let public morality die in India. Let the citizens observe only the Eleventh Commandment: "Thou shalt not be found out".

The implication of 97.75% income-tax is that it is more profitable for a citizen at a certain level of income to evade tax on Rs. 30 than to earn honestly Rs. 1,000. If an individual with an income of Rs. 60,000 a year, increases it to Rs. 6,00,000 a year by dint of sheer hard work, the net additional income in his hands after income-tax would be only Rs. 23,650. In some democratic countries, such rates of income-tax and wealth-tax may be struck down by the Court as being unconstitutional and as amounting to confiscation of property.

The remark that the tax rates in India cannot be reduced because of widespread evasion, is on a par with the observation that you should not go into water till you have learnt to swim.

It is well recognised that a high level of taxation is not disinflationary but positively inflationary, because if the solution to the problem of inflation is more production, then a high level of taxation which reduces the margin of saving and the amount available for investment, is a potential inflationary force. Further, it destroys all cost consciousness as it destroys all ethics consciousness : a company has as little incentive to economise when 70% of its expenses are met by the Government, as a citizen has to be honest when there is virtually a ceiling on the income he can earn by his own labours. As W. Arthur Lewis, the well-known Democratic Socialist, has observed in **The Theory of Economic Growth :**

> "The distribution of income raises peculiarly difficult problems for the less developed countries, in so far as they wish to combine equality with incentives and with a high level of savings. Economic growth demands that there shall be adequate differentials for skill, for hard work, for education, for risk bearing and for willingness to take responsibility.......
>
> "The less developed countries have awakened into a century where everybody wishes to ride two horses simultaneously, the horse of economic equality, and the horse of economic development. The U.S.S.R. has found that these two horses will

> not go in the same direction, and has therefore abandoned one of them. Other less developed countries will have to make their own compromises."

In other words, income-tax rates should be kept reasonably low so as not to interfere with "functional inequalities".

Mr. T. T. Krishnamachari expressed the same view in his Budget Speech of 1957:

> "I have come to the conclusion that our existing rates of direct tax at top levels deprive the tax structure of all flexibility. It is said that they tend to diminish the incentive for work but I am aware that they encourage large-scale evasion. It is now recognised that the very high rates of direct taxation in the top income brackets in many countries of the world in practice are tolerated or tolerable only because of considerable evasion that takes place. In other words, the high rates tend to be applied to a corroded tax base."

Again, in his Budget Speech of 1964, Mr. T. T. Krishnamachari stated:

> ". . . . It is worthwhile mentioning that the motivating factor behind earned incomes should not be ignored. Much of it is due to the incentive, the initiative and hard work of the earner himself, and for keeping up this effort and to enthuse the earner to greater efforts, it is necessary for him to have a feeling that at least some substantial portion of what he earns is left in his hands."

Prof. Kaldor, a confirmed Socialist, recommended the lowering of the maximum marginal rate of taxation on personal income to 45%, and observed:

> "As it is, these confiscatory tax rates truly apply only to a small minority of people who cannot avoid their incidence, and their long-run effect is bound to be wholly pernicious, both in penalising the prospects of certain careers which are vital from the national point of view, and in undermining public morality."

The middle-classes will be the worst hit by the Budget. Every citizen with wealth exceeding Rs. 1 lakh will now have to pay tax on his entire wealth without the exclusion of the first slab of Rs. 1 lakh which prevailed till this year. The effective rate of capital gains tax has been jacked up by nearly 50% in a large number of cases of middle-class investors. There will be no exemption from wealth-tax in respect of any equity shares issued after 31st May, 1971. The 5-year tax holiday to newly established industrial undertakings and hotels takes the form of exemption of profits up to 6% of the capital employed in the company; and a similar exemption is available to shareholders in respect of dividends declared out of such profits. This year it is proposed to exclude debentures and long-term borrowings from the definition of "capital employed". The result will be that for all practical purposes the income-tax relief to companies and their shareholders will be reduced to 2.5% of the real capital employed instead of 6%, since the ratio of long-term debts to equity is generally 4 : 3 in such cases. All this is bound to affect the investment market very adversely and create road blocks in the way of talented young entrepreneurs entering the industrial field, getting financial support from the public, and developing their ventures with due regard to economies of scale.

The Government's hope that tax evasion resulting from confiscatory taxation will be checked by new laws, will prove to be a will-o'-the-wisp. It is a scandalous state of affairs that flats should be sold for half the price in black money. But can you make houses available to the needy at the openly disclosed prices, merely by enacting new laws? The proposed legislation for acquisition of flats by the Government at the price stipulated in the sale deed may prove to be a remedy worse than the disease. It will give tremendous scope for corruption, since only some of the flats would be so acquired in the discretion of the Government officials. Secondly, it would check building activity and aggravate the housing shortage, as the vigorous enforcement of the Bombay Land Requisition Act, 1948, did years ago.

The proposal to have a law barring suits by tax evaders against benamidars to recover properties which had not been disclosed in the tax returns, shows how completely divorced governmental thinking is from the realities of the situation. Practical experience shows that not even one in a thousand benami transactions results in such a suit being filed; because even under the existing law if such a suit were filed by the true owner, he would probably have to pay more in back taxes and penalties than the value of the property itself.

The only effective way of dealing with black money and benami transactions is to end planning for shortages, to reduce taxation to reasonable levels, and to enforce rigorously the existing laws which are quite adequate to deal with the situation.

A comparison with the other countries of the world proves beyond doubt that we are the highest taxed nation, as far as direct taxes on the individual are concerned. The tendency in all progressive countries is to reduce rates of direct taxation so as to stimulate greater effort and greater production. In the United States the rate of personal taxation has been drastically cut, and the maximum marginal rate applicable to earned income after 1971 will be only 50%. In the United Kingdom, the income-tax rates were reduced all along the line in this year's Budget and the top rate was reduced from 91.25% to 75%. An assessee with three children and a widowed mother and paying the usual insurance premium would pay tax at the average rate of 5.5% on an income of £1500. The same income under the same conditions in India would attract 18.3% income-tax.

In Ceylon, Mrs. Bandaranaike's Government has reconstructed the tax system on pronounced socialistic lines, but the highest rate of income-tax there is 65%. There is also a Compulsory Savings Scheme which requires deposits to be made with the Government carrying interest at 5%. But the maximum rate of Compulsory Savings is 20% of the income. Thus the maximum marginal tax along with the maximum Compulsory Savings comes to 85% of the income. As regards wealth-tax, Ceylon, again, is in a much more favourable position. The first Rs. 1 lakh is wholly exempt from wealth-tax and the rate starting with 0.5% goes up to a maximum of only 2% on wealth above Rs. 18 lakhs. Recently, Ceylon did have a capital levy, the maximum marginal rate of which went up to 25% but this capital levy was once for all, as against our maximum annual wealth-tax rate of 8%, going up to 15% in the case of urban immovable property.

Of the 18 important developing countries of the world, six have a maximum income-tax rate ranging no higher than 50%; in another six, the rate is no higher than 70%; in two others 80%, and in the remaining three no higher than 90%. Those three are: Puerto Rico (83%), U.A.R. (90%), and Zambia (90%). India takes the palm with its rate of 97.75%.

The Budget hits hard the corporate sector. At a time when all other developing and under-developed countries of any importance offer incentives for the growth and expansion of corporate enterprises, India alone goes in the opposite direction and takes away existing inducements. The excellent book **"Direct Taxes: An International Comparison"**, brought out by the Federation of Indian Chambers of Commerce and Industry, contains cogent data proving that all developing countries which have any pretence to economic growth are giving, and continue to give, as generous incentives to the corporate sector as India; in fact in many cases the incentives are more generous than what our companies enjoy.

The Government has given notice that development rebate would be abolished in respect of plant and machinery installed after 31st May, 1974 and has expressed the hope that this would result in accelerating the establishment of new industries before that date. The threatened abolition of development rebate by May 1974 is a current deterrent to economic growth and not only a future deterrent. 3,000 applications for licences are pending with the Central Government. The Licensing Committee which meets usually once a fortnight would have to face the impossible task of disposing of 125 applications at every meeting, if it is to deal with all the applications within one year so as to enable the installation of plant and machinery in new industries to be completed before May 1974. The annual accretion to development rebate reserves amounts to Rs. 50 crores and would constitute roughly 20% of the net capital formation in the corporate sector. The unwise abolition of development rebate will increase substantially the tax burden on the corporate sector, drive companies to obtain assistance from financial institutions instead of financing development from self-generated resources, and leave companies free to distribute dividends out of moneys which would otherwise have been ploughed back compulsorily as development rebate reserve. Barely 5% has been the actual rate of growth in industrial production during the last year, as against the 8% to 9% targeted in the Fourth Plan. If development rebate is abolished, the rate of industrial growth will be definitely retarded.

The exclusion of cement, trucks, aluminium, soda ash, petro-chemicals and automobile ancillaries from the list of priority industries will result in their tax burden being increased from 50.6% to 55%. These are high technology-intensive industries requiring substantial doses of capital and a long gestation period and they have a whole chain of beneficial multiplier effects. There is not the slightest justification for their exclusion from the list of priority industries. Every truck manufactured gives employment to 13 persons and 42% of its cost to the transport operator goes by way of taxes to the Central and State Governments. Petrochemicals, aluminium and soda ash provide the raw material base for thousands of small-scale industries.

As regards industries which continue to remain as priority industries, the effective rate of tax has been increased from 50.6% to 52.25%.

The sizably lower relief available to newly established industrial undertakings and hotels has already been referred to earlier. Foreign companies receiving dividends from Indian closely held companies in priority industries will now be taxed at the effective rate of 24.5% instead of 14%. At the same time, foreign companies reinvesting in approved investments the capital gains made by them on sale of their old investments, will no longer be entitled to exemption from capital gains tax. For good measure, the exemption which companies used to enjoy in respect of dividend income up to Rs. 3,000, is also now taken away.

There is not a single redeeming feature in the entire Budget to compensate for the drastic abridgment of incentives for the corporate sector.

Further, companies will not be allowed a deduction in respect of salaries in excess of Rs. 5,000 and perquisites in excess of Rs. 1,000 per month given to Directors and executives, even if their contracts of service have been duly approved by the Government of India. Thus in several cases the executives will pay income-tax at the rate of 90% or more and the companies will again virtually pay tax (as a result of the disallowance) on the same amount at the rate of 55% or more.

When a Government, which is so unfair and unjust, complains of tax evasion, it should remember that just as every nation gets the Government it deserves, every Government gets the tax-payers it deserves.

The incentives for corporate development have been removed, on top of retention of the heavy rates of income-tax and increase in the rate of Surtax. Our companies are charged to income-tax and Surtax, which, in the case of some of the most efficient units, impose a burden exceeding 60% of the company's profits.

Out of the 141 countries whose rates of corporate taxation are available, 131 have the maximum rate of 50% or less in the corporate sector; and, again, 92 out of the 131 have corporate rates not exceeding 40%. Six countries levy corporate tax at rates between 51% and 55%. The only countries whose corporate tax rates exceed 55% are—Austria (57.6%), Sudan (62%), Faroe Islands (87.6%), and Burma (99%). In none of these four countries is there any corporate industrial activity worth the name. Faroe Islands (to the North of Scotland) have a total population of 38,000, i.e. less than that of a small township in India; and in Burma corporate taxation represents more a practical joke than serious economic thinking, since there is no business, no industry and virtually no private corporate sector. Thus, India cries aloud for recognition as the country with the highest burden of corporate taxation.

There is the story of the monks who belonged to a religious order which prohibited them from complaining. One evening, sitting at dinner, a monk found a small mouse in his tankard of beer. Mindful of the rule against complaints, he turned to the Superior and meekly said, pointing to the monk next to him, "There is no mouse in my brother's beer". When one points out that there is no mouse in the agriculturist's beer, one is only pointing out the iniquity of subjecting the urban sector to a staggering burden of direct taxation when for political reasons agriculture is almost wholly spared.

The annual national income from agriculture is about Rs. 16,000 crores, while the total income of the non-agricultural sector is roughly the same. Agricultural income-tax levied by the States totals only Rs. 13 crores, while direct taxes on the non-agricultural sector aggregate to Rs. 857 crores. Thus, though agricultural income is half of the national income, its share of the direct taxes collected is only 1.5%. Land revenue collected throughout India comes to Rs. 113 crores; and therefore even treating land revenue as a part of direct taxation on agriculture, agriculture bears only 13% of the total burden of direct taxes.

Since 1961-62 prices of agricultural commodities have risen by 101%, while the prices of industrial products have risen by only 50%. Further, a substantial part of the increase of 50% in the prices of industrial products is itself due to the sharp rise of over 100% in the prices of agricultural commodities. This is because Indian industries, unlike American and German industries, are heavily dependent on agriculture for their basic raw materials. For example, the price of cotton has increased by 47% in the last three years alone. Again, the sharp increase in food prices dominates the Consumer Price Index to which wages are linked in many industries. Thus, higher food prices result in an increased Cost of Living Index and that leads to increased wages and increased cost of industrial products. In short, the facts are that agriculture is mainly responsible for the inflationary spiral, and the agricultural sector is permitted to increase prices without any control from the Government and without bearing any income-tax burden. This shows how completely divorced from facts and realities is the myth propagated by wily politicians year after year that business and industry are "gently spared" in India.

Instead of the unprecedented additional tax burden of Rs. 220 crores, there are four ways in which the estimated deficit of Rs. 397 crores could have been met:

First, India should pursue the modern fiscal policy adopted by all progressive countries, which is to make revenues grow, not by increasing tax rates but by making incomes grow and the gross national product grow. In other words, tax revenues must be made self-generating and buoyant by expanding the industrial and agricultural base.

Secondly, the Government should teach by example the virtue of economy. There is ample room for saving, without sacrificing efficiency, in the defence expenditure of Rs. 1,240 crores, and the mounting civil expenditure.

Thirdly, the investment of Rs. 3,902 crores in the 85 enterprises in the public sector is expected to yield a profit of only Rs. 51 crores in 1970-71, i.e. a profit of 1.3%. It is imperative that the public sector should be energised and invigorated into yielding a reasonable return.

Fourthly, although agricultural income-tax is not a subject within the competence of the Union, there is a constitutional way in which the Union can effectively induce the States to levy agricultural income-tax, so that the burden of direct taxation may be shared alike by citizens in the same income brackets in the urban and rural areas. There are various grants and allocations which are in the discretion of the Central Government under the Constitution, and the discretion should be so exercised as to favour those States which raise revenues from the agricultural sector.

The founding fathers of our Republic conceived India as the dwelling of the Spirit of Liberty, where social justice would prevail and the nation would be enriched by the enterprise and labour of its citizens. It is the cardinal principle of social justice that labour and enterprise should be fairly rewarded. But our fiscal policies make this country fit only for blackmarketers, tax-evaders and politicians to live in.

If this year's Budget is any indication of the future pattern of the policy of the Government, its invisible social cost is sure to be a further debasement of the nation's character, debased as it is even now, and a nation without character is a nation without a future.

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

—A D. Shroff
(1899–1965)
Founder-President,
Forum of Free Enterprise.

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