

Tax Reform in India

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Whether the political or social urges which led to the recent reforms continue to prevail or not, I am convinced that the Indian tax system could not be frozen still at the point which it has now reached. If an effective tax structure is to be created, reform will have to be carried a great deal further; if on the other hand political forces were to become dominant which would effectively bar this development, there would be little point in preserving such a complicated system of taxation.

Among the new taxes the expenditure tax and the gift tax are so heavily riddled with loopholes and exemptions that they bear only a superficial resemblance to the taxes whose introduction I originally recommended.

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Even if these loopholes were plugged, the administration of the system will not become effective until far-reaching reforms are introduced for checking tax evasion.

I fully maintain the view that with a system of direct taxation of the kind I suggested, the maximum of rate of income-tax should not exceed 15 per cent, it should be evident, however, that, this system has by no means been fully adopted; nothing has been done to tighten up business taxation, while the new taxes, owing to the truncated form in which they have been adopted, will only produce a fraction of yield which they would have produced otherwise.

AN effective system of progressive direct taxation is vital to the survival of democratic institutions in India. The need for this arises not merely on financial grounds to raise adequate resources for purposes of accelerated economic development but in order to bring about the degree of social cohesion and co-operation that is essential for the successful functioning of a democratic system. In a community where there is such a wide gap between the position of a privileged minority of well-to-do and the vast majority who live in dire poverty social cohesion can only be achieved if economic inequality is effectively lessened and the tendency towards increasing concentration of wealth is effectively counteracted. This can only be done through the instrument of taxation. It is in any case inevitable that heavy burdens should be laid on the broad masses of the population, if India is to attain a satisfactory rate of development in the coming decades. It will not be possible to carry through this programme successfully with the consent and co-operation of the people if the privileged minority of the well-to-do are not made to bear a fair share of this burden. Moreover in matters of taxation, like in the administration of the law, it

Substance of an address given to the informal consultative committee of the Parliament in New Delhi on December 16, 1958.

is not enough that justice should be done it must also be seen to be done. If owing to defects in the tax law, or in their administration, highly progressive taxes on wealth or income have no visible effect on the prevailing economic inequality, or in the standards of living of the rich, the mere enactment of advanced tax legislation will prove fruitless.

A Fair Start

In the last few years India has made a fair start towards creating an effective system of progressive taxation with the introduction of the new taxes on capital gains, on wealth, on personal expenditure, and on gifts. It has thus laid the basis for a system which may serve as a model to other democracies, both developed and underdeveloped. But it is no use blinking the fact that, the reforms so far introduced are, at best, a beginning; that the legislation of some of the new taxes is seriously defective whilst the measures for their effective administration have not yet been provided; and that other and equally important reforms in the field of business and company taxation have not been tackled at all. Unless some of the recent legislation is amended in important respects, and unless it is supplemented by legislation in other fields and by far-reaching reforms in the administrative field, there is a serious risk that this noble attempt at

creating an egalitarian democracy will end in failure.

Whether the political or social urges which led to the recent reforms continue to prevail or not, I am convinced that the Indian tax system could not be frozen still at the point which it has now reached. If an effective tax structure is to be created, reform will have to be carried a great deal further; if on the other hand political forces were to become dominant which would effectively bar this development, there would be little point in preserving such a complicated system of taxation.

Among the new taxes the expenditure tax and the gift tax are so heavily riddled with loopholes and exemptions that they bear only a superficial resemblance to the taxes whose introduction I originally recommended. Though the new capital gains tax represents a considerable advance on the form in which it was originally enacted in India, it still suffers from serious shortcomings which undermine the basic purpose of personal income taxation of securing equality of treatment between different tax payers. The wealth tax alone was enacted in a form that is comparatively free from loopholes, though this too contains features that could justifiably be criticised.

Defects of Expenditure-Tax

The most serious defect of the Expenditure-tax Act is that it ties the liability to this tax to a

minimum income limit which opens the door to endless manipulations and is bound to make the tax largely ineffective in practice. Expenditure represents an alternative base to income for measuring spending power or ability to pay. The difference is only that the latter taxes savings and exempts dis-savings, whereas the former exempts savings and brings dis-savings into charge. There is much to be said (for administrative and other reasons) for making use of both principles of taxation, and levying some of the taxation on an income base, and some on an expenditure base. But it is essential, in this case, that the liability to the one should not be made dependent on the extent of the liability to the other. By making the liability to the expenditure tax dependent on the size of income, a concession is made to savings without making a corresponding charge on dis-saving.

This is far more serious than it may appear at first sight since it is always *open* to any tax payer to make his income smaller than it could be (even though he may not always be in the position to make it larger). This provision thus makes it possible to a taxpayer to telescope his income into particular years in which his spendings are kept low, and to telescope his spending into those years in which his income is kept low enough to entitle him to exemption from the expenditure tax. It is therefore bound to have a highly destructive effect—one is almost tempted to say that this particular provision alone makes the tax a little more than a show-piece.

In addition, the Expenditure-tax Act contains a long series of exemptions of various kinds—such as expenditure on marriages, on medical expenses, election expenses, the purchase of cottage industry products, etc—which have no counterpart in the income tax laws and which will make it very difficult to administer it effectively. I do not wish to argue the moral or economic justification for exempting any particular form of personal expenditure from taxation—any one of these exemptions may have something to be said for it, either on grounds of fairness or expediency. But it is surely inequitable to exempt particular categories of

personal outlay from expenditure taxation if these are not also exempted from income taxation.

For the great majority of people income provides the sole source of expenditure; their ability to spend is confined by income taxation just as effectively as by expenditure taxation. If it is not justified to reduce a man's liability to income-tax on account of his having exceptional expenses to bear on illness or on wedding for example, why is it justified to reduce his liability to expenditure tax? Why should people whose source of spending is capital as well as income be more leniently treated than people whose only source of spending is the income which they earn? And (bearing in mind the high exemption limit to expenditure tax and the low exemption limit to Income tax) why should the necessitous expenditures of large spenders be so carefully looked after when the necessitous expenditures of small and moderate spenders are not? From the point of view of equality of treatment whatever concessions are made on grounds of necessitous expenditure for the one tax ought to have their counterpart in the other tax.

Gift Tax Equally Defective

Analogous criticisms can be made against the Gift-tax Act, which in its final legislative form is only a pale shadow of what it was originally intended to be. The purpose of a gift tax, like that of the estate duty, is to restrict the freedom of Individuals to pass on their property rights to others. As the American economist Henry Simons once said, the whole of private property, and the income derived from it, is a gift from the community. It is only by the will of the community that particular individuals can enjoy the privileges of ownership protected by law and administration; and the constantly evolving property laws define the actual nature of the rights which these privileges confer. Inheritance taxes are, in effect, a form of limitation on the privileges conferred by ownership: they allow an individual (subject to various limits circumscribed by law) the unfettered enjoyment of his own property, but they do not allow him to pass on his property unhindered to the next generation.

But if this limitation is held to be justified, on what basis can one differentiate between inter-vivos gifts and gifts by deed of will?

There is a long list of exemptions in the present Gift-tax Act which has no counter-part in the Estate-duty Act; and the provisions of that Act are so framed as to make it possible for an owner through the mere process of spreading the gifts over time to reduce the incidence of the gift tax to a small fraction of that of the estate duty, or even to avoid the tax altogether. As is well known, it was the introduction of the estate duty which led to the wholesale passing on of property by means of inter-vivos gifts so as to avoid that duty.....hence the need for a gift tax. But the present tax, by failing to integrate gifts over successive years for tax purposes, and by giving a series of exemption to gifts of particular kinds (including a large annual exemption) entirely fails in this purpose.

These loopholes in the expenditure and the gift tax legislation are bound to reduce the yield of these taxes to a small fraction of what they should have been which in turn is bound to create agitation for their complete removal. Opponents of these taxes are certain to ask, if such complicated taxes yield so little, what is the point of having them at all?—ignoring the fact that the low yield will be the very consequence of the loopholes and exemptions on the introduction of which they have insisted. In the absence of loopholes, the gift tax and the estate duty taken together at the current rate schedule, *could* be expected to yield some 20—30 crores of rupees annually. As it is, the combined yield will amount to less than one-fifth of this sum. The expenditure tax, properly administered, and in the absence of the present loopholes, should yield at least 15—20 crores of rupees at the current schedule of rates. In its present form it will hardly yield one-tenth of this sum.

Incentive to Convert Income into Capital Gains

With regard to capital gains the new legislation has the great advantage over the old one in that capital gains are now integrated with other forms of income for

income tax purposes. But they are not liable to Super-tax, which means that they are only liable to a maximum rate of tax of 27.5 per cent, whilst other kinds of unearned income are liable to a maximum rate of 84 per cent.* There is therefore still a very considerable incentive for converting income into capital gains, and thereby reduce the effective taxation of those who are in a position to benefit from it to well below the rates applicable to other tax payors. Moreover, while the new law disallows certain of the exemptions provided in the original Act, the important loophole of exempting transfers of property through inter-vivus gifts and through inheritance remains open, which means (if American experience is any guide) that only about one-third of the capital gains made by each generation come effectively within the tax net.

The effective rate of taxation of capital gains, even in the absence of any evasion, will thus not be 27½ per cent, but something more like 10 per cent.

There is undoubtedly some force in the contention that a high rate of tax on capital gains (such as the combined maximum rate of income tax and super-tax at present might have highly undesirable economic effects. But this provides an argument not in favour of a discriminatory treatment of capital gains, but in favour of reducing the rates of taxation on ordinary Income. There is no real justification for continuing the discrimination between income which takes the form of capital gains and other income; they both gene-

I cannot, incidentally, see the advantage of maintaining the distinction between earned and unearned income once the wealth tax is introduced—it means using two separate instruments for the same purpose. It is true that the present wealth tax rates are very moderate. The effective rates are only one-third of the Swedish rates and yield only about two-thirds of the schedule of the rates which I recommended. But it is better in that case to increase the rates of the wealth tax than to maintain the sur-charge on unearned incomes.

rate the same spending power, and both represent the same taxable capacity. The maintenance of the high marginal rates of income-tax thus serves neither the interests of equity nor of revenue if it provides the justification for the continuance of the differential treatment of capital gains or for the maintenance of other equally serious loopholes in income-tax legislation.

Elastic Definition of Expenses

Of the latter the wide and elastic: definition of deductible expenses in the case of business profits is undoubtedly the most important. So long as the owners, directors and managers of businesses are able to pass off so much of their living expenses as business expenditure the incidence of taxation is bound to remain highly arbitrary, and the effective rate of taxation on the business community will remain much below the apparent rate. In my report I suggested that the range of deductible expenses should be confined to "expenses wholly, exclusively and unavoidably incurred in earning the profits of the year" (as against the present rule which permits the deduction of all such expenses which are "wholly and exclusively laid out or expended for the purpose of trade"). This would undoubtedly strengthen the hands of the Revenue in disallowing expenses of various kinds, though the extent to which it will succeed in bringing the treatment of business Incomes fully into line with that of contractual incomes will depend on the interpretation given to it by the Courts. It is a matter for consideration therefore whether, in addition to a stricter general rule for deductive expenses, the deduction of particular types of expenses (such as the so-called "expense accounts", entertainment outlays, private cars, etc) should not be explicitly prohibited,

A further source of loopholes arises from the non-integration, or incomplete integration, of total family wealth and Income. To close this it would be necessary to aggregate minor's income and property with that of the parents, and to include agricultural income and property within the scope of the Union income tax, wealth tax and capital gains tax. This latter

reform may require a constitutional amendment which, however, might well be carried with the support of the States, if the revenue resulting from the extension of these taxes to agriculture is earmarked to the States,

Tax Evasion

Even if these loopholes were plugged, the administration of the system will not become effective until far-reaching reforms are introduced for checking tax evasion. The compulsory disclosure of Benami holdings, the abolition of the system of blank transfers of shares and of bearer shares are essential ingredients of this. The introduction of a comprehensive reporting system on capital transactions and of a single comprehensive return for direct taxation are other necessary ingredients. These are matters within the purview of the Direct Taxes Administration Enquiry Committee recently set up and it is very much to be hoped that their recommendations will pay due regard to these basic requirements of the efficient administration of an integrated tax structure.

In closing I should like to refer to two particular matters on which the Government of India has frequently been criticised for its failure to follow my original recommendations. One relates to the failure to reduce income-tax to the maximum rate of 45 per cent and the other to the extension of the wealth tax to companies.

45 per cent Income-tax

I fully maintain the view that with a system of direct taxation of the kind I suggested, the maximum of rate of income tax should not exceed 45 per cent. It should be evident, however, that this system has by no means been fully adopted; nothing has been done to tighten up business taxation, while tin new taxes, owing to the truncated form in which they have been adopted, will only produce a fraction of yield which they would have produced otherwise. In their present form, and with the present administrative techniques, the new taxes will hardly yield 20 crores.

In the absence of these gaps in legislation and with an efficient system of administration, they should produce at least 50 crores more—quite apart from the gain in

income tax revenue resulting from lower tax evasion, and the disallowance of certain classes of business expenses. As against that the loss of revenue resulting from the reduction of income tax to the ceiling rate of 45 per cent would only amount to 18 crores. I doubt whether the interests which agitate for the latter would willingly exchange the present high rates of surtax for these further legislative and administrative changes which would involve them in additional taxation amounting to several times this sum.

Wealth Tax on Companies

As regards the wealth-tax on companies, I would agree that this does not serve the same purpose of securing equity in the distribution of the burden of taxation as the wealth-tax on individuals. On the other hand it is no more inequitable than the taxation of the profits of companies as such they both involve the taxation of legal entities over and above the taxation of individuals who own them, and on principles which are unrelated to the taxable capacity of the owners. But considered as an alternative to a higher rate of profits taxation on companies, it has this to be said in its favour that its economic affects are distinctly more favourable than that of the profits tax. For it penalises firms who earn a low rate of profit on the capital which they employ and favours those firms whose earning power is high. It thus rewards efficiency and penalises inefficiency, and in the present stage of India's development, it is well worth while to offer special inducements to companies who use the resources at their command efficiently. For this reason I should favour putting more of the burden of taxation on companies in the form of a wealth tax, and less in the form of a profits tax, - i.e., of raising the wealth tax rate (which at 1/2 per cent is very low) if the combined income-and-profits tax rate on companies were correspondingly reduced.

Many other features of the present company tax legislation, such as the excess dividend tax, run completely contrary to this and these ought to be abolished and the whole system of company taxation rationalised and simplified without delay,



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