CHAPTER VI

TAXATION IN A GROWING ECONOMY

In this chapter, an attempt is made to examine four important questions of tax policy in relation to development. The first is the importance of tax compared with other sources of revenue. That is, tax has to be compared with deficit financing and public debt, the other two important sources of revenue and the relation between them is to be analysed. Secondly, limits of tax in an underdeveloped country are to be indicated. How much tax is to be raised to meet the development needs of the public sector is an important issue, because the magnitude of other sources will depend upon this factor. Thirdly, there is also the need to discuss the kind of the tax system that will be suitable for the underdeveloped countries. Since the effects of different taxes on the economy are considered to be different, a broad framework of a tax policy which will fulfill the objective of fiscal policy as laid down in the last chapter will be noted down. Finally, this analysis will be extended to India in which the present tax structure will be examined and future possibilities indicated.

Importance of tax resource as a fiscal instrument:

It has already been noted that the important problems of fiscal policy in an underdeveloped country are (i) raising resources for the development of the public sector, (ii) furthering of development in the private sector, (iii) control of inflationary tendencies in the economy, and (iv) improvement in the distribution of income and wealth. These objectives are not only unexceptionable in themselves but are, in many ways, crucial to the process of ordered economic growth and progress.
However, the important question here is, how far can tax policy assist in the realisation of these objectives? The issue can be examined by comparing tax with other sources of revenue.

(a) Tax and Deficit Financing:

As has already been stated, deficit financing has inflationary implications in underdeveloped countries. A small measure of deficit financing is desirable, nay, inevitable in the process of development. But in the light of inflationary pressures existing in underdeveloped countries, a heavy dose of deficit financing will inflict serious injury on the economy. Therefore, there should be caution in the use of this technique in accelerating the process of development.

What about taxes? It is generally believed that taxes permit increased government spending without inflation. Most of the economists suggest that, in an inflationary situation, there should be increased reliance on taxes to reduce consumption and increase investment. It is true that by and large, taxation draws upon the common pool of savings, formed by the surplus over consumption in the economy, which is available for use by the public as well as private sectors. 'It is comparatively easy for the tax system to secure a diversion of savings from private to public use, but it is very much more difficult to bring about an enlargement in the total volume of savings available for investment. Taxation reduces both (private) consumption and investment (1).

However, if the tax system is properly used and proper incentives are given to the private sector, taxation can increase the ratio of savings to national income without

c Curtailing private investment. Since the major problem in an underdeveloped country is capital formation, inflation is to be avoided not by cutting down investment, but rather by raising the rate of savings so that a high rate of investment may be sustained without undermining stability.

Even if taxation increases the resources available to the public sector by a significant draft on those available to the private sector, it does not necessarily imply that taxation, even at high rates, reduces investment in the aggregate. If taxation goes to increase the volume of public investment, and not to swell administrative and non-developmental expenditure, total investment will be larger to the extent that additional public investment made possible by taxation takes place at the expense of not private investment but of consumption. In fact, taxation may be a most effective means of increasing the total volume of savings and investment in any economy where the propensity to consume is normally high (2).

This means that taxation is better than deficit financing since the former will facilitate new additional investment without creating inflationary pressures. Some recent literature, however, suggests that taxation may aggravate rather than alleviate inflationary pressures. The arguments given in favour of this are (i) the tendency of increases in taxation is likely to fall on saving rather than spending, (ii) the tendency for increases in taxation is likely to be passed on in higher prices of factors and products, and (iii) there are likely to be adverse effects of increases in taxation on incentives, including the incentive to tax evasion and avoidance. Since these arguments have direct bearing on the problem of financing development in

(2) Ibid, p.149.
underdeveloped countries, a brief discussion of this question is in order.

(1) The first argument i.e., the increase in taxes will reduce saving rather than consumption has some prima facie plausibility. Consumption patterns are more or less rigid. If people are used to a particular standard of living, they are extremely reluctant to forego such benefits. Again, hire-purchase system also enables consumers to continue their consumption at the same level. In such cases, even though net savings of individuals become zero, increase in taxation does not produce, so the argument runs, much effect in controlling consumption.

This does not, however, mean that the entire effect of increased taxation will fall on saving. Family budget rigidities do not apply only to spending, a large proportion of personal saving now-a-days is subject to contractual commitments, for mortgage and hire-purchase repayment, life insurance, etc. For persons most of whose saving takes this form, a cut in disposable income due to increases in direct taxes or indirect taxes on goods of inelastic demand is much more likely to fall on marginal spending, at least in the short-run (3).

There are various estimates as to the effect of additional taxation on saving and consumption. Bergson's computations indicate that an income tax increment equal in total to 5 per cent of the aggregate family income of 1935-36 would come 61 per cent of-the-agg out of saving, if the new taxes were laid at rates as progressive as those already in existence. If the additional tax were simply at a flat rate of 5 per cent on all incomes, only 30 per cent of it would come out of saving. Goode's study is based on 1941-42 family budget

data. The tax that he is testing is that part of the corporate income tax that may be assumed to reduce the individual's disposable income through its effect in curtailing dividends. His computations indicate close to half of this part of the corporation income tax came out of the individuals' spending, the other half out of their saving. Kaldor, using British data, and studying the effects of a uniform percentage increase in all taxes, direct and indirect, concluded that 27 per cent of such a tax increase would have come out of saving, 73 per cent out of consumption (4).

Whatever the relevance of these estimates may be, they clearly indicate that taxation has some effect on consumer spending and to that extent, it is anti-inflationary. If there are temporary indirect taxes on durables, there may be either substitution or postponement of consumption. Deferment of spending is as significant in the short-run as the direct effect of such taxes in reducing personal disposable incomes (5).

(ii) It is further argued that collecting taxes is inflationary because increases in taxes will lead to compensatory increases in factor incomes. One such factor income is wage. It is said that increases in taxes will increase wages and when taxes fall on increments of profits, the natural resistance of employers to wage increases will be reduced. In other words, the argument is that higher taxes lead to higher wages and that higher wages in turn lead to higher prices.

Although this is theoretically possible, this does not necessarily mean that there is a perfect link between taxes and wage increases in case of all taxes. The danger is probably

(5) Arndt, op. cit.
greatest with sales tax because of its direct impact upon the cost of living. It may also occur with taxes on business profits since employers may not hesitate to money-wage increases in periods of prosperity. Of all possible levies, personal income tax on wages and salaries or the spending tax probably offers the least danger of generating factor-price increases. At most, the argument that taxes may be inflationary by leading to wage increases means only that, if anti-inflationary tax policy is to be effective, proper taxes should be selected for attaining the objective.

What about the effect of taxes on other factor incomes? It is said that if taxes on business profits are increased, businessmen will shift the burden of such taxes in higher prices. In fixing prices, businessmen take the tax as a part of the cost of production and raise prices to compensate the loss. Therefore, increase in taxes is likely to lead to inflation.

This argument also does not seem to be correct. A tax on a commodity per unit affects the cost of the marginal producer as well as of every other producer and, therefore, tends to be added to the price, because whatever increases marginal cost must ultimately increase price. But a tax on income is a tax on net profits; and net profits are not cost, but the surplus over cost. A tax on profits cannot reach the man who makes no profits. If the man at the margin who at any particular time fixes the price for the entire supply of commodities that is sold in the market pays no tax, tax on income cannot be added to the price. In other words, the tax on profits is paid only by the man who makes profits, that is by the intra-marginal producer, not by the marginal producer. But the tax paid by the intra-marginal producer cannot affect the price which is fixed by the marginal producer who pays no tax (6).

Some of the modern economists do not believe in this traditional answer of the marginalist theory and point out that businessmen can actually shift the burden of taxes to consumers. Assuming that the marginal approach is wrong, it does not necessarily mean that a businessman can increase price at any time he likes. Whether he can get the price which he has set depends not upon himself, but upon market conditions. Where the price competition is strong, he has to bear the whole of the tax increase. Again, if a businessman has to increase the price due to increase in taxes on business profits, he can pass on the tax gradually over a period of a year or two. The disinflationary impact of such increases may be considerable and it is the short-term effect that counts. Finally, even if tax increases are passed on in higher prices, they achieve the primary object of a disinflationary fiscal policy for the control of demand inflation. Provided money incomes do not increase (or atleast do not increase in proportion) the rise in prices reduces the real incomes of consumers and thus squeezes out excess demand (7).

(iii) Then there is the incentive argument. The collection of taxes may destroy the incentives which are the very main springs of economic growth. Taxes which fall on the wage earner may diminish the incentive to work harder and better; taxes which fall on profits of enterprise or on the higher-income groups may undermine the incentive to save and to make investments in new (and hence risky) enterprises. Taxes on output or income of farmers may reduce the incentive to improve agricultural techniques. And so on. If increase in taxes has these adverse effects on incentives, there will be reduction in the supply of

effort and, therefore, the supply of goods and services. But in considering the effects of taxation through its influence on incentives, it is necessary to take into account the effect of government spending. If an increase in taxes becomes inflationary due to its adverse effect on flow of goods and services, the government expenditure on economic and social overheads may have a very stimulating effect on incentives to work or to invest. Moreover, different taxes have different effects. In selecting taxes for development finance, greater emphasis may be given on taxes whose effects on incentives are less than those of others. In general, one may, therefore, conclude that taxation is certainly anti-inflationary in their effects (8). That means additional resources can be raised by increasing taxation without creating inflationary pressures in underdeveloped countries. In so far as this is possible, taxation is better than deficit financing in raising resources, promoting private investment, controlling inflation and securing equitable distribution of burden of developmental finance on all sections of the community. Again, since some deficit financing is inevitable, a proper system of taxation is necessary to control the adverse effects of the former. Taxation is, therefore, both a substitute and a complement to deficit financing.

(b) Taxation and Borrowing:

While on the one hand it is said that increased taxation leads to inflation, on the other hand it is stated that it is contractionary in its effects and, therefore, it should be curtailed to accelerate the process of development. There is no doubt that the public debt is more expansionary than taxation. That is why it has already been suggested that public debt should be increased to finance development. But this does not mean that

taxation is deflationary. It was once thought that tax-financed government expenditures were neutral with respect of the nation's level of income and employment - that the expansionary effect of a rupee of spending would be offset by the contractive influence of the same amount of tax collections. More recently, however, it has been shown that a balanced budget has income-generating effects even if the marginal propensity to consume is assumed to be the same among payers and receivers of the government funds (9).

The analysis shows that an increase in tax-financed expenditures will increase the Gross National Product by the amount of the additional government spending. Because the taxpayers and recipients of government expenditures are assumed to spend equal proportions of their marginal incomes on consumption goods, parallel changes in taxes and expenditures can have no effect on the level of private spending - reduced consumption spending by one group will be offset by the increased consumption spending of the other. With no change in expenditures in the private sector of the economy, it follows that a net change in Gross National Product equal to the change in government expenditures (and taxes) must occur. The change in Gross National Product will reflect a change in output and employment when the economy is operating at less than full employment. It is, therefore, reasonable to say that tax-financed public expenditure is expansionary in its effects.

Probably in a growing economy, there cannot be much choice between taxes and loans to finance development. All resources have to be tapped in order to meet the demands of the economy. In that sense, loans are as necessary as taxes. But if economic effects of the two are compared, it will be seen that taxes are better than loans from long-term point of view. For example, taxes do not create a problem of repayment of interest of capital in future whereas loans do. This does not mean that borrowing shifts the burden of government activities to future generations. There is no shifting of the basic burden to the future because while future generations inherit obligations to pay interest and principal on the debt, they also inherit the bonds themselves. Thus when interest and principal payments are made, there occurs only a transfer within the future generations, and no real burden. What is emphasised here is that the borrowing method admittedly creates some problems for the future generations in the form of adverse effects on the economy from the taxes necessary to pay interest and principal. A national debt is a burden on the economy if the taxes necessary to finance the interest charges on the debt are heavy enough to damp incentives to bear risk in investment and to work. The payment of interest may have also a net detrimental effect on the economy by creating a rentier class which can live without working. Such problems do not arise in the case of taxation.

Again public debt is likely to aggravate inequality if it is concentrated in the hands of the high-income groups (directly or through institutions). The problem of concentrated ownership of the public debt becomes particularly important when the debt is expanding rapidly. For then it requires a high rate of saving and it is only the high income groups and the savings institutions that can provide the necessary rate of saving (10). Taxes have the

(10) D. Hamberg, op. cit. p.597.
advantage that they can raise savings without increasing inequality in the economy.

Moreover, borrowing from commercial banks may provide the groundwork for a large-scale inflationary threat. This is particularly true if the government is forced to engage in large-scale borrowing to increase the pace of development. When expansion of the debt leaves a legacy of liquidity behind it as to create a distressing inflationary threat, it becomes desirable to increase taxes to mop up the extra spending power to control consumption. Taxes at this stage become necessary both as a complement and a substitute to borrowing.

It is sometimes said that taxation should be used strictly for the purpose of balancing the budget on current account, and the capital part of the budget should be met entirely by borrowing and not through a budgetary surplus. As the Taxation Enquiry Commission have observed, it is difficult to support such an unqualified statement. Current and capital expenditures do not fall into categories which can be sufficiently clearly distinguished for this purpose (11). The capital account is not confined to financially productive projects for which loan finance may be considered appropriate by orthodox economists. The programmes of development expenditure, which figure in the capital budgets, contain a certain proportion of expenditure for development of social services like public health, education, etc. Even the economic development programmes included therein, though intended to raise productive efficiency and, therefore, highly worthwhile, are not all productive in the strict financial sense. Therefore, tax financing is as desirable in case of capital expenditure as loan financing from the strict orthodox point of view.

Another argument which is advanced against the use of taxation for capital expenditure is that there is no justification for burdening through taxation, the present generation with the whole cost of development programmes intended to benefit future generations. The Taxation Enquiry Commission rightly points out, 'The argument contains the hoary fallacy of assuming that a part of the current cost of development can be shifted to posterity. There is no way of securing this postponement of the cost, in terms of real resources, of a large investment programme: The programme involves a deduction, here and now, from the resources available to the community for current consumption. The question of the relative use of taxation and borrowing relates, therefore, not to the question of distributing the burden between the present and the future, but to the appropriate method of meeting, in the present, the cost of the investment programme. A decision on the question only determines the distribution within the community of the burden imposed by the investment programme; for the community as a whole, this burden has to be borne in real terms in the present' (12).

This does not mean that the entire development programme should be financed by taxation. The importance of loans has already been emphasised. All that is said here is that a part of the development finance should be borne by taxes and the question of burden on the current consumption has no real significance. Taxes do not cause any greater real burden on the community than would be done by an equivalent amount of public borrowing. The experience of post-war development in other countries shows that the inflationary potential of a big development programme 'can be held within bounds by an appropriate degree of surplus budgeting on revenue account' (13).

The above analysis shows that taxation is the most effective fiscal instrument for raising resources for the development of the public sector, furthering development in the private sector, controlling inflationary pressures and improving the distribution of income. A developing country can, therefore, escape from increased taxation only at its own peril.

Limits of Taxation:

If this is agreed, the next important question is: What should be the level of taxation in an underdeveloped country to finance development? It must be noted in the beginning that there is no absolute limit to taxation. It has been rightly said by Dalton that absolute taxable capacity is a myth (14). The limit of taxable capacity is relative to the purpose for which the proceeds of additional taxes are expended. If taxes were levied to improve the productive capacity of an economy and there were a large degree of correspondence between taxes and the beneficial expenditure which they make possible, the limit of taxable capacity would be higher (15). In an underdeveloped country, since taxes are used for the purpose of the development of the economy, there is a great scope for increasing the taxable capacity.

Again, taxable capacity also depends on the size of the national income and its distribution. If a larger proportion of people's income is devoted to consumption of an unessential kind, there can be a substantial increase in taxation. Even though the size of income is low in underdeveloped countries, the unequal distribution of income may enable the government to raise more taxes than what they are raising now from the economy.

(14) Principles of Public Finance, op. cit., Note to Chapter XII.
(15) L.H. Kimmel: Taxes and Economic Incentives, Ch.I.
The nature and methods of taxation should also be taken into account in determining taxable capacity. For example, if the government raises only one or two taxes, however good and progressive they might be, the limit to taxation is likely to be reached very soon. But if the revenue system is composed of different types of taxes and presumably, the critical limit of each tax occurs at a different level, the taxable capacity can be increased to a considerable extent. The more comprehensive is the basis of a tax system the higher is its capacity because the higher is the element of surplus in the tax payment (16). This is illustrated in diagram VI - 1.

Diagram VI - 1 shows that the government will use the first tax that involves the lowest marginal social cost. When the first reaches a certain level of revenues, the marginal social costs of further use of the tax begin to exceed those of another one. This is where the first tax reaches its capacity. Further revenues will be raised by a second tax until it, too, will reach its capacity when its marginal social costs will exceed those of a third tax and so on. For example, if revenue needs are only $BA$, first tax is imposed. If there is need for more revenue, both first and second tax will be imposed, $BH$ by the first tax ($BA + AL$ ) and $BL$ by the second. If more revenue is needed, there is need to increase the first and second tax till they reach their capacity. That is, taxes will be increased to $BA+AL+BL+LN+L1$. If this is not sufficient, there will be a need for the third tax. And so on.

This, however, does not make a case for imposing a large variety of nuisance taxes. That will irritate the taxpayer, injure the long-term interests of the economy and yield

DIAGRAM NO-VI-1

TAXABLE CAPACITY OF THE TAX SYSTEM

MARGINAL SOCIAL COST

THIRD TAX

SECOND TAX

FIRST TAX

TAX REVENUE
insignificant revenue for the government. If tax system is made simple and some major taxes with high yielding power are imposed, the taxable capacity can be considerably increased.

On the basis of experience of different countries Mr. Colin Clark has suggested that the 'safe limit' for taxation in a non-totalitarian country is 25 per cent of the national production and that, if taxable capacity thus defined is exceeded 'for more than two or three years; prices will rise and production stagnate (17). The major argument of Clark is that high taxation would reduce incentives and impair production. Besides this, Clark has also given two more arguments which are worth mentioning. Firstly, high tax rates would weaken the resistance of employers to wage demands and encourage them to make wasteful expenditure. A rise in taxation might be temporarily effective in reducing spending power and easing the pressure on supplies and costs, but if it is continued for any length of time it could cause costs again to rise and make the situation worse (18). Secondly, tax increases may not reduce private spending. Consumers may continue their previous level of consumption by drawing upon their liquid balances. Clark has given statistics from many countries to show that high tax rates and increase in prices have gone together.

The arguments of Clark, though formidable, do not provide any theoretical justification. Statistics by themselves do not prove or disprove anything. Joseph A. Pechman and Thomas Mayer have shown that rise in prices in many countries pointed out by Clark was not due to high taxes but due to large deficits and


(18) Colin Clark points out that Keynes agreed with him on this point in a private letter dated 1st May 1944. See 'What is wrong with Economics', 'Encounter April 1958.
other causes (19). It can be proved on the contrary that high
taxes may weaken the substitution effect and thus producers may
sacrifice their leisure in order to earn higher income. Similarly,
employers may have greater capacity and justification to resist
higher wage demands. It is difficult to give any empirical
evidence in these cases. Mr. Clark himself has argued that a great
many families are quite unaware of how much of indirect taxation
they are paying (20). This weakens his disincentive argument.
Moreover, the incentive effect of high rates is related to the
marginal rates of the different taxes employed and has little
relevance to the total tax burden. There is no such correlation
between high average rates and high marginal rates (21).

Finally, if tax rates continue to remain high for a
long time, inducement to invest may not be impaired as workers
and employers would try to adjust to the new circumstances and
sacrifice leisure in order to earn more income than before.
In fact, in many of the industrially advanced countries like
U.K., U.S.A. and W.Germany, the maximum tax rate has gone beyond
25 per cent and yet the incentive to save and invest and for
entrepreneurial activity has not been retarded. On the other hand,
in many of the poor countries, tax rate is much lower than what
has been prescribed by Colin Clark and there is much scope for
further improvement in the tax system. In India, the tax rate is

(19) Pechman and Mayer: 'Mr. Colin Clark on the Limits of
(21) For example, in the U.S.A., the marginal rate of Federal
tax on corporate profits was 22 per cent whereas in the U.K.,
it varied between 52.75 and 62.5 per cent before 1951,
depending on undistributed profits. Yet total taxes were a
much larger proportion of national income in U.K., than in
the U.S.A. See 'Colin Clark on the Limits of Taxation',
op. cit.
about 8 to 9 per cent of the total national income and according to the Taxation Enquiry Commission, 'there is a presumptive case for holding that Indian taxation on the basis of its existing structure and rates has not fully tapped the taxable resources of the country' (22). Prof. Kaldor also lends support to this and points out that 'the tax revenue does not exhibit that natural buoyancy - i.e. the automatic rise in yields with the increase in national production and income - which is a common feature of the tax system of Western Countries' (23). Colin Clark's thesis does not, therefore, seem to be applicable to all countries.

If Clark's thesis is not accepted, it does not mean that taxes should be increased to any extent. A very high tax may injure productive effort and efficiency of the economy. Moreover, there exists in every situation a certain psychological limit of taxation which cannot be passed without strong reactions. 'The economic limits are qualified by political limits and these are usually reached earlier, especially in communities which function on a democratic basis with the widest franchise. In certain circumstances both these limits get qualified by administrative considerations relating to the problem of enforcement' (24). The problem of taxable capacity should, therefore, be considered in relation to other methods of financing economic development.


Prof. Morag in considering the capacity of taxation in relation to deficit financing, points out that taxation will reach its capacity when the marginal social costs of further taxation exceed the costs of borrowing from banks and the wise decision is therefore: no more taxes (25). This means, taxable capacity is reached when it is wise not to impose more taxes. Such a situation might be arrived at either because the social costs of taxation exceed at the margin those of other sources of finance, or because taxation becomes impotent as an anti-inflationary tool.

This approach to taxable capacity does not give us exactly how much tax level can reach at a particular stage, but it tells us which method of finance is better to meet the demands of the public sector. If taxes are found superior to other methods, taxes are to be increased, but if at a certain level of taxation, the marginal social sacrifice of deficit financing is lower than the marginal social sacrifice of further taxation, deficit financing should be resorted to. The relation between deficit financing and taxation is presented in diagram VI - 2.

Thus, in diagram VI - 2, the limits of taxation will be reached at that amount of tax revenue where the curve of the marginal social costs of taxation intersects from below the curve of the marginal social costs of deficit financing. The curve of the marginal social costs of taxation rises because the marginal utility of disposable income increases with a decrease in disposable income, and hence the marginal disutility of paying taxes rises with the level of taxation. The first tax gives OA amount of government revenue, the second tax AC and the third one CD. Clearly, when development expenditure necessitates a revenue larger than OD, deficit financing may have to be resorted to in order to finance additional outlay, since at the margin it is less costly.

DIAGRAM NO-VI-2

RELATION BETWEEN DEFICIT FINANCING AND TAXATION

MARGINAL SOCIAL COST

GOVERNMENT REVENUE

FIRST
SECOND
THIRD

V DEFICIT FINANCING
This analysis has the advantage that it does not prescribe the limits of taxable capacity for an underdeveloped country. Poverty of a country is not relevant to the size of its taxable capacity. To argue that an economy has taxable capacity is to preach for an inferior system of financing. This shows that taxation has an important part to play in development finance.

**Direct and Indirect Taxes:**

If that is so, what kind of taxes are to be levied for increasing the rate of development? Should all taxes play equal part or should there be some differentiation between different types of taxes? This requires a careful study since the controversy regarding the effects of different taxes is not yet resolved.

For example, for a long time income tax was considered preferable to commodity tax as the incidence of the latter was uncertain and even when it was assumed to fall on the final consumers of particular commodities, the scope of differentiation was narrow and unsatisfactory. On the other hand, a tax levied directly on income could not normally be shifted on to others, so that it generally fell on those on whom it was intended to fall and it was capable of being differentiated according to personal circumstances of taxpayers. The regressive nature of commodity taxes was also fairly widely recognised. Since the rich are in a position to spend their money on a variety of commodities, they could to some extent escape taxes by purchasing goods which cannot be brought within the scope of commodity taxes. Income tax has the advantage that it could be graduated and could satisfy the social conception of equity in the tax system.

Again, it was demonstrated that a given amount of tax collected from a given individual by a commodity tax would leave him in a welfare position inferior to that in which he
would be left if the same amount of tax were collected from him by an income tax. On revenue consideration, therefore, income tax was considered better, since revenues could always be obtained advantageously by this tax (26). This is explained in diagram VI - 3.

In figure VI - 3, W R is the pre-tax price line for X, W B the amount of X bought at this price by an individual, and AB the amount of money income spent by him on X. An imposition of an excise on X changes the price line from W R to WT; the amount of X bought falls to W D and the new amount of money income spent on X is C D. But out of C D, C F represents the payment of the excise on X. If the government is indifferent to sources of revenues (as long as they are tax revenues) and is interested only in their money size, an income tax H W may be substituted for the excise tax C F. Since H W is equal to C F, the government still gets the same amount of tax revenues from the individual. But this substitution, to which the government is completely indifferent, is in favour of the individual who is transferred by it from indifference curve I₃ to the higher indifference curve I₂. As a matter of fact, the burden of paying C F as an excise tax is equal to the burden of paying W G as income tax, as both leave the individual on the same indifference curve, I₃. H G represents, so the argument ends, the excess burden of the excise.

The most important defect of commodity tax was taken to be its impact upon allocation of resources. Taxes on specific commodities are likely to change relative prices (unless the demand for the taxed commodity is perfectly inelastic) and as a

DIAGRAM NO-VI-3
THE EXCESS BURDEN OF INDIRECT TAX
result of this, resources will be moved out of the taxed industry into other lines of production. The resulting production pattern is likely to be inferior to that which would have prevailed in the absence of such taxes. As a matter of fact, the more unequally tax falls on different commodities, the greater is the provocation to taxpayers to rearrange their expenditure so as to economise on the use of heavily taxed items and worse is the distortion in the existing production pattern (27). But income tax in this respect is considered superior as it is entirely neutral as between different lines of expenditure. If man's income is reduced by a certain sum, he would spend the income in the same way as he would spend a similar income without any income tax. This is illustrated in diagram VI - 4.

Suppose with given resources, two homogeneous commodities X and Y are produced. The consumer at the point Q reaches maximum welfare position and at this point the combination of X₃Y₃ is produced. At the point Q, the transformation curve is tangent to the indifference curve I₃ i.e., the consumer's marginal rate of substitution of X for Y (the slope of I₃ at Q) is equal to the marginal rate of transformation between X and Y (the slope of X₀Y₀ at Q). Under perfect competition the ratio of prices of Y and X (i.e. \( \frac{PY}{PX} \)) will be equal to the consumer's marginal rate of substitution between X and Y and to the marginal rate of substitution between X and Y in production. The price ratio, \( \frac{PY}{PX} \), is the slope of the iso-revenue line AP.

Now if a tax is imposed on X, the iso-revenue line will be changed and a combination containing more of Y and less of X will be produced. Let us say the new iso-revenue line will pass at the point \( Q_1 \) and the new combination of X₂Y₂ is produced.

DIAGRAM NO-VI-4

EFFECTS OF COMMODITY TAXATION ON THE PRODUCTION PATTERN AND CONSUMER WELFARE

UNITS OF

Y

A

C

V₀

Q₁

Q

UNITS OF

X

X₂

X₃

X₀

B

D

g₁

g₂

g₃
This allocation of resources obviously reduces consumer welfare (since indifference curve I₂ is lower than that of I₃).

But if an income tax is imposed, money income will fall and so AB will also fall. This will give rise to unemployment unless PX and PY fall by an amount sufficient to restore AB to its original position. In a competitive economy, prices would do all the adjusting and no unemployment would emerge. It follows that consumers would be in the same real position as before, because there has been no reduction in output. Although money incomes after deducting taxes fall, prices also fall. Unless an income tax affects transformation curve, consumers are left at the same satisfaction levels as before the tax.

These arguments imply that income tax is superior to commodity taxes and it is desirable to depend on the former to increase economic wellbeing. But the whole argument is based on three assumptions. First, it is implicitly assumed that there are ideal conditions: that is to say, that when considering the 'Tax Problem', the analysis is started from a position in which there are no taxes in existence. Secondly, it is assumed that the supply of work is completely inelastic with respect to changes in the rates of income or outlay taxes. When this assumption is removed the simplicity and the correctness and the certainty of the so-called proof disappears. Finally, the theoretical demonstration of the superiority of direct to indirect taxation is based on welfare grounds of the individual consumer. When considering the case of an individual tax payer it was reasonable to take his payments to the Exchequer as a good measure of the burden of government finance upon him. When we come to consider the community, however, we have to modify this approach and take into account the effects of the taxes.
on the economy, both as instrument of price policy and regulator of inflation. The following analysis takes these factors into consideration and shows that both types of taxes are necessary in underdeveloped countries.

(a) Allocation of Resources:

The idea that commodity taxes may alter resource-product allocation and that tax-induced reallocation is always inferior from the consumer's point of view is not always correct. If resources are optimally used and if rates of transformation and market values are equal, indirect tax seems to be inferior. But since optimum conditions are not always satisfied, a general case cannot be made out against indirect taxation. In theory some will be good and some will be bad. For example, if in the figure VI-4, the consumer is on point $K$ on $Y_0X_0$, a tax on $X$ would put consumers on higher indifference curves as long as the production of $X$ was reduced and $Y$ increased thereby to the quantities indicated by $Q$ or $Q_1$. The 'excess burden' contention rests on the assumption that the relative quantities of various commodities produced are ideal in the absence of excise taxes. If this is not true, there is no priori reason for supporting that excise taxes must make consumers worse off. In actual practice, in an economy with many products and in which economic welfare is not maximised, taxes upon production may move allocation towards or away from the ideal (28). In actual practice, in an economy with many products and in which economic welfare is not maximised, taxes upon production may move allocation towards or away from the ideal.

Rolph and Break have also shown that the demonstration of the excess burden argument is based on the assumption that the reduction in output of the taxed commodity is not compensated at all by an increase in the output of other commodities and hence consumers must be worse off. Such an approach implies that the released resources disappear from the economic scene. This does not seem to be a correct position. When we consider the effect of tax changes on living standards, we must take into account of gains in the output of non-taxed items occasioned by the reorganisation of resources. If this is done, excise taxes may improve or worsen living standards.

Besides, even when a commodity tax makes allocation of resources inferior, this can be avoided by means of compensating devices in the form of taxes and subsidies. Suppose there is a tax on commodity X and no tax on commodity Y, this injures those who consume relatively more of X and benefits those who consume relatively more of Y. In this case, consumers injured by a reallocation can be subsidized until they are no worse off than before. On the other hand, those who are initially benefited are to be taxed in order to provide the subsidy to those injured. Such reorganisation can continue and when no such reorganisation is possible, maximum welfare is attained. So if commodity taxes are otherwise desirable, they should not be discarded on the ground that they lead to inferior allocation of resources.

(b) Instrument of Price Policy:

This leads us to the point that indirect taxes can be better relied upon in those cases where it is necessary to make intervention to adjust differences between marginal private and marginal social net products, or where, as in the case of alcohol, it is desired to distort consumer preferences as an act of policy.
Even in Soviet Russia where due to planned economy, the sovereignty of the consumer has been restricted to a considerable extent, the government has thought it better to adopt consumer choice (through non-proportional commodity taxes) which enables the Soviet authorities to allocate resources in a proper manner and avoid the high cost of direct distribution of consumer goods by rationing. The ability to equate supply and demand by commodity tax as well as by adjustment of output allows the planners, as pointed out by Holzman, considerably more freedom from consumers' interference than would be possible if income tax were the sole available fiscal instrument (29). That is why the Soviet economists stress the importance of commodity tax as an instrument of price policy.

In Soviet Russia, commodity taxes have provided the bulk of national revenues. Turnover tax is the most important tax. This tax has provided nearly 50 per cent of the total national budget and 90 per cent of the revenues from turnover taxes is derived from taxes on food and other consumption goods. In Japan also, it was indirect taxes on consumer goods which largely financed the growing requirements of the national budget from 1880 to 1913. In India and other underdeveloped countries where planning has come to stay and regulation of prices on social interest has become indispensable, the importance of commodity taxes cannot be minimised. They are probably more convenient due to administrative difficulties of direct controls.

(c) **Incentive**:

From the point of view of incentive, income tax is considered unsuitable. It is said that at high marginal rates

of income tax may have a very serious effect in reducing output by reducing the incentive to work; in more general terms it distorts the choice between activity which earns a money income (liable to tax) and any other activity. It is, therefore, argued that income taxes should be reduced in order to increase the supply of factors.

The excess burden of direct tax is presented in the diagram VI-5. The question is that direct tax can reduce the supply of factors of production—i.e., the supply of effort.

Suppose $L_0$ in diagram VI - 5 represents the position of idleness — no work and no income position. $OY_0$ is the income received — no leisure. If a constant hourly wage is paid the opportunity line is $L_0Y_0$. Equilibrium position is $Q_1$.

Now suppose there is a tax on income. So there is a new opportunity line $L_0T$ which is drawn so that for any point $P$ on the $L$-axis, $OP$ represents the leisure enjoyed, $PQ$ the income before tax and $PT$ the income after tax. The new equilibrium is given by $Q_2$. Tax is $Y_1Y_0$ from the Exchequer point of view. From the point of view of tax-payer it is $Y_2Y_0$. So the excess burden is $Y_2Y_1$.

The sample survey that was carried out for the Royal Commission on the Taxation of Profits and Income, in which 1,429 workers in England and Wales were interviewed about their reactions to taxation, 73 per cent of the men and 60 per cent of the women said they thought that the income tax tended to reduce output because of its disincentive influence (30). That is why in underdeveloped countries, there is persistent demand that direct taxes should be reduced in order to generate private investment (31).

DIAGRAM NO-VI-5

EXCESS BURDEN OF DIRECT TAX

LEISURE

MONEY INCOME
It may be that high income tax has an adverse effect on the aggregate work-supply, but to be dogmatic about this is not probably a correct position. High indirect tax may also have the same effect on the supply of factors. Henderson has pointed out that, when people work to obtain goods, their incentive to work is affected in the same way, by taxation, when the goods they can obtain from an hour's work is limited by direct or by indirect taxation. But the method of indirect taxation has the further disadvantage of reducing the efficiency with which those resources can be used, and therefore, an added burden is imposed (32). If this is accepted, it would mean that both direct and indirect taxes upset the 'optimum' balance between work and leisure and therefore, there is nothing to choose between them from the point of view of incentives.

However, assuming that income tax reduces incentive to work more than commodity tax (due to money illusion), it is worth while to consider whether such disincentives are of much significance. If income tax impairs incentives by reducing the net monetary reward to be earned by an extra hour's work, it also exerts pressure on the taxpayer to work harder in order to maintain his prevailing standard of living. On theoretical grounds, it is difficult to say that income tax has only disincentives and no incentives. Fray's empirical study on income tax and its effect on incentives to work shows that

(32) A. Henderson: The Case For Indirect Taxation, The Economic Journal, December, 1948, pp. 538-553. The apparent advantage of indirect taxation according to Henderson in its effect upon incentive is due simply to the fact that a change towards indirect taxation is usually accompanied by a reduction in the degrees of progression in the tax system as a whole; the same effect upon incentive with a smaller burden on the community could be obtained by a corresponding reduction in the progressiveness of the income tax.
'disincentive, like the weather, are much talked about, but relatively few people do anything about them'. In fact, tax-payers complain bitterly how little they are allowed to keep out of every pound they earn, but they go on doing the work just the same. On the basis of data collected in England, Breâko points out that 'contrary to the frequently repeated injunctions of so many financial commentators, solicitude for the state of work incentives does not under current conditions justify significant reductions in the role of progressive income taxation'. On the other hand, he has suggested that in the United States, income-tax rates could be raised considerably, especially in the middle and upper-middle income ranges, without lowering unduly the aggregate supply of labour (33).

In underdeveloped countries, not only is the income tax rate much lower but the fiscal programme of the government is likely to provide sufficient scope for the expansion of private enterprise. Hence there is no justification to criticise direct taxes on the ground that they are disincentives. During the post-war period in India, the government actually tried to reduce direct taxes in order to increase private investment. For example, taxes on income which accounted for 48 per cent of the total tax revenue in 1944-45 were reduced to 36.6 per cent in 1946-47 and 28.2 per cent in 1950-51. But the volume of investments in the country did not respond to tax incentives (34). The obvious conclusion is that disincentives of direct taxes are probably

(34) Nanda K.Choudhry : Indian Taxation Policy 1946-51 and Private Investment, Indian Economic Journal, July 1955. Though there might have been other considerations to reduce private investment, the fact that tax incentives did not increase investment is important from our point of view.
The traditional theory of public finance did not clearly describe the anti-inflationary effects of taxation, because its adherents lacked a developed theory of income. The orthodox rules of annual budget balancing and of taxation, however, implied that all taxes with the same yield have equal anti-inflationary effects. But it is now considered that the effects of different taxes are different in regard to the extent of anti-inflationary effects and so there is a need to compare the desirability of different taxes in a period when inflation control is desired.

The anti-inflationary nature of a tax depends upon its effect on the economy. The more the tax reduces spending and the less it cuts production, the more anti-inflationary it is. From the point of view of reducing consumption, commodity taxes are considered superior to income taxes because commodity taxes are regressive in character and as such, they reduce consumption much more than income taxes. People in the lower-income groups spend a larger proportion of their incomes upon goods and services that would be taxed than do people in the higher income groups. Low-income consumers have less opportunity to maintain their purchases of commodities for they have little saving. On the other hand, income tax is likely to be paid out of what might have gone to savings and so there is less decrease in consumption (36).

(35) Though our study refers to the effect of income tax, we make a general statement because of all the direct taxes, the disincentives of income tax are considered to be more than that of others.

The problem is illustrated in diagram VI-6. The analysis of figure VI-3 is further extended here. In figure VI-3, we have seen that CF excise tax is equal to HW income tax. But if he pays HW in income tax than if he pays the same money amount, CF, as an excise, his consumption of X under the income tax is WL, while it is only WD under the excise tax on X. The fact that E must be to the right of C is the core of the alleged excess-burden of indirect-tax argument. If an income tax were also to cut the individual's consumption of X to WD, the revenue from it should have to be increased to WN, and the individual will be transferred to the position P, which on indifference curve I₄, the lowest of the four. If the government is interested in releasing BD of X from consumption it should be indifferent whether it gets WN as income tax revenue, or only WH as excise tax revenues. But in this case, the individual definitely prefers the excise. HN is, so to say, the excess burden of general income taxes.

It is, therefore, argued that a system of commodity taxation takes on many characteristics of an income tax, but with two distinctive merits; it does not involve penal treatment of marginal earnings as does the income tax. Secondly, and more important, it allows savings to be exempted from taxation (37). This means, as a method of inflation control, commodity tax is better than income tax.

Especially in underdeveloped countries where income tax is paid only by a microscopic minority, a commodity tax has greater advantage to control inflation than an income tax. In case of India, for example, only about one per cent of the people pay income tax and even so, all their incomes are not brought under taxation. Since current income is the principal source of (37) Prof. Tess : Lloyds Bank Review, July 1953, p.38.
DIAGRAM NO-VI-6

EFFECT OF DIRECT AND INDIRECT TAX
ON CONSUMPTION

MONEY INCOME

QUANTITY OF X
expenditure, the effectiveness of the tax is reduced as the individual income tax does not reach all persons and all incomes. That is why, U.K. Hicks points out that in primitive conditions, a general progressive income tax is not adequate and recourse must be had to commodity taxes which have some of the same effects (38).

These arguments lead to the conclusion that from the point of view of inflation-control, indirect taxes are more effective than direct taxes. But this does not seem to be true always. The standard argument that attributes stronger deflationary effects to commodity taxes than to income taxes is that the marginal propensity to consume declines as income rises. Though this argument has a great deal of plausibility, it is not yet established that the marginal propensity to consume varies from one level of disposable income to another (39). Consumer budget studies in the United States and the United Kingdom have often (though not always) been interpreted as indicating a nearly uniform marginal propensity to consume over the range in which most income is earned. On the other hand, even if, in some cases 'cross-section' data indicate a marginal propensity to consume diminishing with income, redistribution of income will not necessarily affect the total volume of consumption (40). The members of one group may differ from those of another group in other respects, such as tastes, age, family size, occupational distribution, functional distribution of income, urban-rural distribution, the proportion of transitory

(38) U.K. Hicks, Direct Taxation and Economic Growth, Oxford Economic Papers, October, 1956.


to permanent incomes, and the interest rate at which they can borrow or lend. Such differences might so influence the average propensity to consume that total consumption may not be affected. Morag therefore points out, 'All in all, if there is a big difference between the distributional impact of two equi-revenue taxes, the more progressive tax would probably be the less deflationary, but the differences in deflationary effects might be smaller than is ordinarily expected (41).

Again, in a period of rising prices, commodity taxes may raise absolute prices and intensify inflation (42). Because imposition of indirect taxes increases cost of living which gives rise to higher demand for wages and consequently to a more rapid upward movement in prices. An income tax does not give rise to this pressure as the personal exemptions protect the minimum standard of living of the wage earners. If the commodity tax drastically cuts consumption, it may also impair ability or willingness to work effectively. On the other hand, since income tax is considered to be equitable, the imposition of income tax may not impair the willingness of taxpayers to give their full effort for increasing production.

The idea that commodity taxes discourage consumption and promote saving is possible only when consumers expect that taxes are temporary and anticipate declining prices in the future. Otherwise, the tax incentive to defer consumption is of minor consideration. This is the reason why Goode has said that differences between commodity taxes and income taxes as instruments of inflation control are negligible. 'The traditional view, that all taxes of equal yield have', as Goode says, 'much the same anti-inflationary effect seems nearer to the

(41) Ibid, p.269.
truth than recent contentions that taxes differ greatly in this respect' (43).

Finally, income tax has also some peculiar advantage as a method of inflation control. A progressive income tax can be a powerful brake on an inflationary expansion of money incomes. The method of built-inflexibility can automatically collect the increase in income without any new legislation. In order to collect the same yield from commodity taxes in a period of rising income, frequent rate adjustments would be necessary and due to the inevitable delay of legislative procedure, the result may be far from satisfactory. Individual income tax is, therefore, considered as an effective anti-inflationary instrument (44). It is true that income tax does not reach the whole of the national income, but the part it reaches provides an adequate base, while the part it does not reach largely represents a necessary minimum which has a strong claim to be shielded on grounds of equity and of working efficiency.

The conclusion therefore is that both types of taxes have advantages and disadvantages in controlling inflation.

(4) Conclusions

This survey leads us to the conclusion that the controversy between direct and indirect taxes is sterile.

Walker rightly points out, "It seems to me unfortunate that such a barren topic as the 'Direct-Indirect Tax Problem' has occupied such an important place in Public Finance discussions ........" (45). In fact, in any scheme of development you


cannot escape direct or indirect taxes. Both are indispensable in the fiscal programme of underdeveloped countries. Direct taxes are necessary not only for maintaining equity in the tax system, but also for controlling inflation and providing incentives to work. Equity in taxation is as important as justice in administration. If taxes have to be increased on the masses to augment resources for the economic development, a fair share of the burden should be borne by the privileged few. As it is, the average quota of direct taxation is relatively low in underdeveloped countries and a number of direct taxes can easily be increased without causing any detrimental effect on private capital formation. If there are restrictive effects, they can be corrected by a system of tax concessions and exemptions.

However, too much reliance on direct taxation may not serve the purpose of equity. Because, even though a progressive tax is likely to have lower marginal social cost than a regressive tax, after the tax has reached a certain level, it is better to use a second tax which is less desirable than the first. After a certain level, the disutility of the progressive tax becomes greater than that of a commodity tax. It is true that an income tax is much better than a sales tax or an excise duty, but an excessive increase in income tax is not necessarily better than a commodity tax.

Again, direct taxes may secure the required revenue or control inflation provided their scope can be increased considerably and different incomes can be calculated to enforce tax measures. As it is, the environment is not suitable for the successful working of direct tax. The following major impediments may be noted: (1) The lack of money economy,
(2) Lack of high standard of literacy among taxpayers to fill up the forms or file claims for exemptions, refunds, etc. (3) Absence of accurate accounting records, (4) Lack of tax responsibility, and (5) Inefficient administrative machinery (46).

In view of these difficulties, direct taxes cannot be expected to play an important part in underdeveloped countries in initial stages of development. If these facts are taken into account, one cannot escape the conclusion that indirect taxes are as necessary as direct taxes. The regressive character of commodity taxes cannot be altogether eliminated. But if there are high rates on luxuries and low rates on articles of common consumption, a broad element of progression can be introduced. This will have the fruitful result of increasing revenue and at the same time diverting productive resources from less to more socially desirable channels of production. If properly formulated, indirect taxation can actually achieve three main objectives for the development of economy. They are: (a) raising resources for public investment; (b) raising the rate of investment in the economy by curtailing the consumption of luxuries; and (c) raising the incremental saving ratio.

All the three are interrelated. Since additional resources are necessary for the development of the country, all have to contribute something. Indirect taxes are desirable in the sense that they can reach all persons and can be assessed on all commodities. But this does not mean that there should be taxes on essential commodities consumed by the poor. As there is scarcely an element of surplus in the incomes of the masses of

the people, it would be undesirable as well as unjustifiable to
force them to contribute to economic development out of their
meagre incomes (47). Therefore, there is a need to impose
additional taxes on a wide range of luxury or semi-luxury
products, at a fairly substantial rates, accompanied by broad-
based taxation of articles of mass consumption at comparatively
low rates.

This will not only add substantially to the revenue
resources of the government, but also restrain a rapid expansion
in the output of many non-necessaries and luxuries. One of the
important problems of development in case of underdeveloped
countries is to divert resources used in production of
non-essentials to essential consumer and investment goods.
Discriminating rates of indirect taxes on different objectives
of money expenditure as suggested above will facilitate
reallocations of resources which may be helpful to the growth
of the economy.

At the same time, taxes on mass consumption goods on
moderate rates have to be imposed in order to siphon off a
part of the additional income accruing to the common man due
to increased development. Raising the incremental saving ratio
is one of the most difficult problems in underdeveloped
countries. It is not enough to increase savings from the richer
sections of the community. In so far as a substantial part of
the increase in incomes accrues to the poorer section of the
population, they are in a position to consume more than before.
If their marginal propensity to consume approaches unity, the
increases in productivity may be fully absorbed by increased
consumption and there may be nothing left for additional
(47) Fiscal Policy in Underdeveloped Countries, op. cit. p.86.
investment. Increased commodity taxation could be used at this juncture to restrain increases in consumption and thus release some factors for purposes of investment (48).

It follows from the above analysis that a properly diversified scheme of taxation should be adopted both to increase the resources of the public sector and to maintain proper balance in the economy. In other words, "the tax system must have an adequacy of both depth and range, if it is to promote an accelerated pace of development". (49).

**Tax structure for an underdeveloped country:**

On the basis of the above discussion three principles may be set down for the tax structure of an underdeveloped country. First, taxation policy should enable the public sector to obtain savings sufficient to finance the programme of economic development and increase the country's national income. This is the fundamental problem. As Buchanan and Ellis point out:

'While neither ideal equity nor optimum yield may be expected of the tax system in many countries, the improvement of revenue system throughout the underdeveloped world offers one of the greatest unexploited instruments of economic progress' (50).

For this, both direct and indirect taxes are to be comprehensive, direct taxes for securing revenue from the upper strata of the society and indirect taxes to touch all that should and can participate in the process of development. However, while raising taxes, attempt should always be made to mop up the surplus that exists in a particular sector. Such surpluses may

(48) Ibid, p.86.
(50) Approaches to Economic Development, op.cit. p.333.
exist either in agriculture or industry. But generally, in underdeveloped countries, a great part of the surplus originates in the agricultural sector and is appropriated by landowners, money lenders and merchants who usually do not possess the habit of productive investment. Whether the surplus is in agriculture or industry, one of the central tasks of taxation policy is to mobilise the surplus for purposes of economic development (51). That means, the bare necessaries of the poor should be spared so that they can be able to maintain the minimum consumption necessary for efficiency and for incentives. In case of the rich, taxation should be extended to all sources of income which are not used for productive investment. If this is done, the taxation policy would secure revenue for the government for productive use and at the same time, restrain consumption over a wide field which may check domestic inflationary pressures in the country. Both are equally useful in an underdeveloped economy.

Secondly, taxation should mobilise a part of the initial increases in income in order to prevent initial improvements in productivity from being dissipated in accelerated consumption or in increased leisure. This can be done by the imposition of betterment levies. The capital expenditure by the government for irrigation or electric power, necessarily tends to be concentrated in certain areas which also get most of the benefit of such development. If a part of the cost of such projects is defrayed by special adhoc taxes levied on the people in the area, it is conceivable to realise a part of the additional income from the projects without much resistance.

(51) Fiscal Policy in Underdeveloped Countries, op.cit., pp. 64-65.
Such taxes may be called 'development-taxes'. Besides, there may be permanent measures to build flexibility in the tax system so that the tax yield will be progressively more responsive to increased incomes. In most of the underdeveloped countries, income-elasticity of taxation is very low and unless effective measures are taken to improve this, the share of taxation in total incomes cannot rise and the role of the public sector in accelerating development cannot be strengthened.

Finally, tax increases should be of a kind that does not destroy incentives for private undertakings of a development nature. The major problem in a poor country is to stimulate an increase in the flow of savings and investment or increased effort for risk-taking. As Mrs. Hicks points out, "Naturally the outlines of a tax structure tailored for development will look substantially different in a conventional underdeveloped country than in a highly sophisticated economy like ours (England) (52). Therefore, a tax system which by its very nature cannot be evaded, and which nevertheless gives due weight to incentive features, is of particular importance for an underdeveloped country."

Granted the above, what should be the tax structure for an underdeveloped country? To begin with, there must be a radical improvement in the progressive taxes of the underdeveloped countries. In most of the underdeveloped countries, income tax is the only progressive tax and it is also subject to a number of limitations. For example the rates of income tax are much lower in underdeveloped countries than in developed countries. This is especially true of the lower and middle income groups among the tax payers, the rates in the upper ranges of the

(52) U.K. Hicks: Direct Taxation and Economic Growth, op.cit.
income scale often being quite high. The study of Martin and Lewis shows that in underdeveloped countries the general practice is to have high exemption limit for personal incomes so that a man earning an income comparable to £ 200 a year usually escapes altogether income taxation (53). In India, the exemption limit is ₹3,000 which is much higher than that of other underdeveloped countries and exceeds ten times the per capita income in the country. In the upper income ranges, the tax rates are very high which are comparable to the rates prevalent in advanced countries. The income tax, super tax and surcharge together result in a marginal rate of 87 per cent on the highest slab of incomes in India. This leads to wide spread evasion. But in the middle and upper-middle income ranges, the rates are low in comparison with the rates in advanced countries.

There is also another difficulty. Income tax does not satisfy equity as it excludes from its base capital gains and losses, gifts, bequests and other gains (54). This requires an over-all change in the tax structure. First of all the income tax itself should be modified. Though the present exemption level may be continued on administrative grounds and people below this level may be reached through indirect taxation the rates of the tax on the middle and upper middle income groups are to be increased. Otherwise sufficient savings cannot be secured for development. But in respect of upper income groups, there may be a need to reduce the rate of taxation to some extent to avoid

(53) Alison M. Martin and W. A. Lewis, 'Patterns of Public Revenue and Expenditure', The Manchester of Economics and Social Studies Vol. XXIV, No. 3, September 1956, p. 223. They have made a comparative study of 16 countries, both developed and underdeveloped including India.

(54) N. Kaldor: An Expenditure Tax. Indian Income Tax in recent years has been changed on the basis of recommendation of Kaldor and it now includes capital gains.
widespread evasion. The loss of revenue on this account can be overcome by imposition of other direct taxes.

In this respect Kaldor's integrated system of tax reform for India is worth examining (55). His integrated system is so designed that efforts to evade one tax will automatically involve the taxpayer in other tax liabilities. In short, the system makes it pay to be honest about taxes. At the same time, it has built in incentive aspects that should contribute to economic growth. The main features of his tax reform are as follows:

1. A personal income tax at rates ranging from zero to 45 per cent. Income is defined for tax purposes so as to include all capital gains.

2. A tax on all assets (wealth) ranging from 0.3 to 1.5 per cent, with an exemption for some small minimum holdings.

3. An expenditure tax ranging from 25 to 300 per cent according to the total amount of consumer spending by a family unit, with an exemption for some small minimum amount of expenditure.

4. A gift tax varying from 15 to 80 per cent according to the total value of gifts made in the tax period.

5. To assist in enforcement, there is suggestion for compulsory auditing of accounts.

6. To check on total spending, income, and wealth, every one of the one million taxpayers would be assigned a code number, which would be entered on all documents arising out of capital transactions.

This is a comprehensive tax proposal to reform the tax system of an underdeveloped country. Kaldor supports this proposal on grounds of equity, economic effects and administrative

(55) N.Kaldor: Indian Tax Reform, op.cit.
efficiency (56). According to him, from the point of equity, the most important consideration is that the tax system should not contain a systematic bias in favour of particular groups of taxpayers and against others; from the point of view of economic effects of taxation the major consideration is to prevent the tax system from becoming too much of a disincentive on effort, initiative or enterprise; and from the point of view of administrative efficiency, the main requirements are simplicity and comprehensiveness, which make for ease of administration and at the same time prevent large-scale evasion.

There is no doubt that from the equity point of view, Kaldor's proposal is much better than the present system. As Kaldor has discussed elsewhere (57), equity in taxation between income from work and income from property cannot be secured unless (i) the concept of 'income' is made sufficiently comprehensive to embrace all beneficial receipts which increase the taxpayers spending power, and not merely the conventional forms of income; (ii) the tax on income is supplemented by an annual tax on capital wealth in recognition of the fact that taxable capacity cannot be adequately measured either by income alone, or by capital wealth alone, but can be approximated through a mixture of both; (iii) in the calculations of taxable income, profit or gain, permissible deductions should proceed on uniform and non-discriminatory principles as between different kinds and forms of income.

From this point of view, a comprehensive tax proposal which includes income tax, capital gains tax, wealth tax and gift tax is desirable. This is a true measure of spending power

(56) Ibid, pp.10 ff.
(57) An Expenditure Tax, Ch.I.
of different individuals. Taxation of capital gains is necessary because exclusion of this involves the privileged treatment of a particular class of taxpayers as against others. Moreover, in a developing economy, the implementation of a programme is certain to create conditions in which assets of all kinds will appreciate. It is fair that the Exchequer should get a proportion of these incomes when realised in the form of capital gains.

The basic reason for wealth tax is that the ownership of property in the form of disposable assets endows the property owner with a taxable capacity as such, quite apart from the money income which that property yields (58). The estate duty by itself is not enough to meet the purpose of a tax on capital. The duty is based upon the accident of death and is imposed on the capital possessed by a testator at the moment of his death. During his lifetime the ability index of capital ownership is not taxed though he continues to enjoy the possession of that capital.

There is also further need to extend wealth tax to individual property especially property accruing from agriculture. Adler feels that since the distribution of real property in most poor countries is more uneven than the distribution of income, a proportional property tax with a relatively high level of basic exemptions would be more progressive than an income tax, and would also be easier to administer (59). It might also discourage the habit of devoting private savings to the acquisition or construction of real property, thereby allowing savings to be directed into more productive investment.

(58) Indian Tax Reform, p.20.
(59) The Fiscal and Monetary implementation of Development Programmes, op. cit.
The distribution of national income in India indicates that the share of property incomes in India and the United States is not very different (60). Patel's figures show that (a) more than half of the national income is accounted for by the income of the self-employed; (b) wages and salaries represent nearly 23 per cent of the total, which is much smaller than the share going to wage and salary earners in the United States; (c) gross income associated with property ownership in India accounts to a little more than 23 per cent of the total. On the other hand, the income from property in the United Kingdom and the United States has varied from 20 to 25 per cent of the total over the last ten years or so. But whereas in the United States the groups which receive this share of the income save a considerable part of it, their counterparts in India fail to do so. Patel, therefore, adds, 'Although per capita income in India is low, the possible rate of savings does not have to be significantly lower than the in the developed countries, for the proportion of the saving-generating income, or gross property income, in both cases is approximately the same. The low rate of productive investment in India may, therefore, be explained, not by a reference to the low average income, but the preponderance of 'feudal' income (in property income), which in the main is sterile, at present for furthering economic development' (61). This emphasises the need for wealth tax on property income in underdeveloped countries.

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. Inheritance tax allows an individual

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(61) Ibid, p.11.
the unfettered enjoyment of his own property, but limits his power to pass on his property unhindered to the next generation. Gift tax limits inter-vivos transfers. If it is accepted that the whole of private property and the incomes derived from it, is a gift from the community, there is no justification to make any differentiation between inter-vivos gifts and gifts by deed of will. Moreover, estate duty may itself stimulate inter-vivos transfer of property to heirs and successors, so as to avoid the payment of estate duty.

From the equity point of view, this integrated structure of taxation seems desirable. But when Kaldor goes beyond this and while attacking taxation on income both from the points of view of equity and economic effects, pleads for expenditure tax, he treads on difficult grounds. According to Kaldor, no definition of income, which is a plausible one for purposes of tax assessment, can measure taxable capacity because the accruals of spending power from various sources cannot be reduced to a common denominator except on some highly arbitrary basis. For instance, ₹.100 of capital gain does not constitute the same amount of spending power as ₹.100 of regularly recurrent receipts. Such difficulty does not arise in case of expenditure tax. Because, when each individual decides the scale of his living expenses, he performs the task of reducing accruals of spending power from various sources to a common denominator. Thus, if expenditure is made the basis of taxation, the problems created by the non-comparability of various types of accruals of wealth resolve themselves. (62).

Then there are disincentive effects of income taxation. According to Kaldor, income tax is inferior to expenditure tax

(62) An Expenditure Tax, p.47.
in four other respects: (i) it discourages saving and risk bearing and hence tends to retard economic growth whereas an expenditure tax does not, (ii) it has greater tendency to weaken work incentives, (iii) it is a less efficient tax in the sense that, per pound of tax revenue raised, it lowers private spending less than does an expenditure tax and (iv) as an instrument of counter-cyclical fiscal policy, it is less precise than expenditure taxes levied on consumption and investment (63).

These arguments show that expenditure tax is better than income tax both on grounds of equity and economic effects. Kaldor however does not argue for the replacement of income tax by expenditure tax. He realises the administrative difficulties associated with expenditure tax as an instrument of mass taxation and recommends that maximum rate of income tax should be reduced to 45 per cent and that realised capital gains should be included in taxable income.

Kaldor's arguments have aroused great controversy. It is not yet established that expenditure is a better index of ability than income. Expenditure tax is not based on spending power possessed, but on spending power actually exercised. The former may measure true index of ability, not the latter. Kaldor argues that if the tax is progressive, the relationship between spending and spending power can itself be taken into account in determining the rate of progression of the tax (64). Even if this were done, if two persons having same income did not spend the same proportion of their income, the tax levied would not be in

(64) An Expenditure Tax, p.49.
proportion to their respective spending powers. Moreover, in order to take this relationship into account it would be necessary to get an idea of total income in each case. This would raise all the problems of measuring true spending power to avoid which the expenditure tax was advocated in the first place (65).

With regard to economic effects of income tax, we have already seen that disincentive effects of income tax are exaggerated. The superiority of expenditure tax over income tax is yet to be established. However, if it is assumed that expenditure tax is likely to promote saving more than income tax, this does not necessarily make a case for expenditure tax. In view of the fact that in underdeveloped countries quite a substantial portion of private saving is devoted to unproductive investment, expenditure tax may not lead to economic growth.

There are again accounting difficulties in case of expenditure tax. As Lakdawala has said, 'Money is spent often in dribbles in a variety of ways on a number of purposes. Income is derived from one or two major sources. Systematic accounts are more frequently kept in case of income and better known to others' (66). As such, expenditure tax cannot be a proper substitute to income or super tax. It may, therefore, be better to build a scheme of partial exemption for savings within the structure of income tax than to replace super tax by expenditure


(66) D.T.Lakdawala : An expenditure tax, The Indian Economic Journal, April, 1956. He has also shown the theoretical difficulties of expenditure tax.
One of the important arguments of Kaldor in support of his scheme is that it is much more evasion-proof than the system he found in India and elsewhere. Evasion control is surely an important consideration in underdeveloped countries. According to Kaldor, in the field of income-tax alone, evasion in India is to the extent of about Rs.200 crores. Though this is considered to be exaggerated there is no doubt that evasion is the rule rather than the exception. In such an environment, a self-enforcing tax system is all the more desirable.

But though Kaldor's system goes a long way in the direction of self-enforcement, it is not a closed system (68). As Kaldor himself admits, it will not prevent evasion if both parties to a transaction gain by concealing or understating it. In his system the seller of an asset does gain from reporting the sale, offsetting the gain to the buyer from hiding it or understating it. But in the case of goods, both buyer and seller gain from concealment or understatement; the buyer reduces his expenditure tax thereby and the seller his income tax. Ultimately Kaldor relies for enforcement on his compulsory auditing and the difficulty of hiding assets.

(67) To check evasion, Expenditure tax may continue. As Kaldor says, if taxes are levied on wealth, income and expenditure, the assesses will have to file comprehensive tax returns. This requirement provides for self-checking in two ways: (a) an assessee has to be consistent in his returns; (b) the attempts of one taxpayer to minimise his liability will immediately increase the liability of another. But expenditure tax may be inadequate for revenue purposes. In case of India, where expenditure tax was experimented on the recommendation of Kaldor, the yield per year was less than one crore of rupees.

Higgins, therefore, improves the system by adding to Kaldor's expenditure and assets taxes a penal tax on excess inventories and a turnover tax. If these new taxes are added to Kaldor's integrated system, it is possible to devise a closed system, so that any one failing to report one taxable transaction will either find himself paying more under another tax, or having the transaction reported by the other party to it, because the other party can reduce his tax liability by honest reporting (69). The employers will report wages and salaries paid out as costs in order to keep down income taxes. Any false reporting in this case can be corrected by the other parties who can reduce their tax liability by honest reporting. Similarly sales will tend to be reported by sellers to avoid excess inventory taxes. But if they hoard goods and report fictitious sales to avoid the excess inventory tax, they cannot escape. The seller would have to pay income and turnover tax on the fictitious sale. The buyer must pay the expenditure tax if the transaction involves consumers' goods and capital gains plus asset taxes if the transaction involves assets. If the fictitious buyer is himself a dealer, he puts himself in the position of being liable to excess inventories tax if he makes many fictitious purchases. Moreover, a dealer who reports purchases but no sales would soon arouse suspicion.

It follows, therefore, that revelation of any transaction in a chain provides the key to the whole chain. There is always some one along the line who will gain by reporting the transaction, exposing any taxpayers who have sought to conceal transactions (70). This system is really an integrated self-enforcing tax system, a system which is indispensable in countries having low tax morality.

(70) Ibid, pp. 527-528.
Apart from that, the *exc* tax on excess inventories is also a useful device to prevent hoarding of goods in underdeveloped countries. Large-scale hoarding of inventories either for security or for speculative gain blocks capital and retards the rate of development. A penal tax on excess inventories may have the beneficial effect of forcing the hoards into the market and creating necessary conditions for a stable economic growth.

The integrated tax structure of Kaldor and self-enforcing tax proposals of Higgins have to be improved further by additional taxation on land. Land taxes have a uniquely favourable place as fiscal instruments because land is the principal source of wealth and income in underdeveloped countries. It has a tax-base which can easily be located and identified. Moreover, the planned economic development of an underdeveloped country is likely to bring about substantial expansion of its agriculture. For one thing, such an economy is usually largely agricultural. For another, it is essential that the supply of food and raw materials should keep pace with the increase in the demand for them that may arise from economic development. It is, therefore, necessary that a progressively higher proportion of the expanded agricultural income should be captured by taxation.

The case of Japan is a bright example. Agricultural taxation played an important part at the beginning of Japan's industrialisation. There was substantial improvement in agricultural productivity during the period 1880 to 1920 in so much so that agricultural output per farm worker rose by 106 per cent. But this increase in productivity was not allowed to improve the standard of living of the people. Heavy land taxes were the device which was used to siphon off a part of the
increment in productivity in agriculture and these revenues were channeled directly into investment projects by government action (71). The land tax was so important at the beginning of industrialisation that it accounted for 86 per cent of the total tax revenue in 1875-76 and 46 per cent in 1893-94. In 1906-07, revenue from land-tax amounted to 57 per cent of the total capital investment in that year.

In Soviet Russia, increase in productivity of agriculture was of great significance as a source of financing a rapid rate of capital accumulation. Soviet farmers, in spite of great increase in agricultural productivity, not only failed to improve their levels of living, but probably experienced a deterioration in economic well-being. With the system of compulsory food collections enforced through the Machine Tractor Stations, the farm population actually became the residual claimant. Thus forced collection of grains was the principal means whereby the gains in agricultural productivity were siphoned off to help finance rapid accumulation of capital.

The experiences of Japan and Russia indicate that increased land taxation should play an important part in accelerating development in less developed countries. Land taxes can be a form of property tax levied on the value of land, or it can be levied on the annual production, or on the rent from the land. Agricultural taxes can also be used to tax large landowners on a progressive basis. Actually, the programme of increased land tax would be helpful in many ways. For one thing, as a

means of mass taxation, it would raise revenue from a broad segment of the rural population who derive benefit due to general development of the economy. They cannot be approached in any other way. If the tax rate is progressive, with a low rate on small cultivators and tenants, the burden will not be heavy. Land tax can also be used for the full productive use of land. If some people do not use land in an economic manner or even keep the land idle for prestige reasons or for purposes of speculation, such practices can be discouraged by imposing land tax at its potential market value, that is, at the value that it would have if it were effectively cultivated (72). Another method in which land tax can be helpful is that as development leads to an appreciation of real estate values, land taxes could make available to the government a part of the windfall (73).

Again, by means of an exclusive tax, additional revenue can be collected from substantial cultivators who are likely to gain more than others in the process of development. A recent estimate in India shows that big farmers, with holdings of 30 acres and over have appropriated more income than that of small farmers. Of the total estimated increase of Rs. 1213.1 crores of income from agriculture during the period of 1949-50 to 1958-59, the share of big farmers comes to Rs. 275.6 crores (74). They have also improved their position due to favourable terms of trade for agriculture compared with industry. This needs the imposition of a special charge in the form of a surcharge on the big farmers (72) Meir and Baldwin, op.cit. p.390.

(73) Taxes and Fiscal Policy in Underdeveloped Countries, op.cit., p.36.
who grow richer than other farmers. Special assessments, betterment levies or irrigation taxes on particular groups of agriculturists who benefit directly from development projects may also be imposed to appropriate a part of the additional income accruing to certain areas of the economy.

The main point here is that tax yield from agriculture should be responsive to charges in prices and production. That means, as Dr. Wald suggests, the appropriateness of land taxes 'must be tested in each country against the same basic criteria that apply to all other taxes ....' (75). This requires some overhauling in land taxation i.e. improved assessment methods, responsiveness of tax yields to price and production changes, incentive land taxation and relation of tax liability to some extent, to the personal circumstances of the taxpayer.

Eventhough improvements can be made to increase the revenues from income taxes, business taxes and agricultural taxes, the major reliance will still have to be placed on indirect taxes in underdeveloped countries. Indirect taxes play a very important part in the finances of underdeveloped countries. Their role cannot be minimised in the initial stages of development. They will also provide a method of breaking down the tax collection barriers of a large non-monetised segment which is usually found in these countries. But the structure of indirect taxation should be fashioned in such a manner that there will be a broad element of progression. If there are high rates on luxuries and low rates on articles of common consumption, there will be no resistance to indirect taxes and people who are

on the margin of subsistence can pay taxes without injuring their health and efficiency. The basic principle of taxation in a poor country is that no additional taxes will be levied on necessities or on low incomes. Tax system should be so modified that it would restrain the consumption of non-essentials or luxuries to the extent that it would provide sufficient resources for the financing of investment (76).

If there would be need to curtail consumption, taxation should be used more for checking potential increase of consumption than for curtailing the actual consumption of the masses. In a developing economy, this is the only justification for mass indirect taxes. Otherwise taxes should fall on non-necessaries that are consumed by a fairly large number of people who are above the subsistence level and luxuries that are consumed mainly by the well-to-do.

In this connection, there is one type of tax which requires special mention, that is, the charges that the State should levy for the services of the capital projects already completed. The problem of pricing public utility services has received a great deal of attention in economic literature. But the problem of pricing from the standpoint of expediting capital formation in underdeveloped countries has not yet received adequate consideration. Whether the State should make profit, incur loss or follow a policy of no-profit-no loss in case of public enterprises is an important problem from the point of view of development and a detailed discussion of this has been given in the next chapter. All that can be said here is that this is a kind of indirect tax and its role in the process of development should clearly be borne in mind.

The implication of the above analysis is that underdeveloped countries should widen and deepen the tax-base, increase appropriately the rates of old taxes and levy new imposts, and at the same time build flexibility into the tax structure so that tax yields will automatically increase along with increase in national income. Tax expansion is primarily necessary to start the cumulative forces, while the income-elasticity of tax structure is essential to sustain the cumulative process.

**Tax Effort in India:**

It was realised in the very beginning that taxes should play an important part in financing the development of the country. In fact, considerable effort was made to increase tax resources during the first decade of planning. Especially the attempt to increase the rate of existing taxes and impose new taxes during the period of the second Plan was encouraging. This is evident from the fact that the total tax revenue of the Union and the States combined were estimated to have risen from Rs. 761 crores in 1955-56 to about Rs. 1355 crores in 1960-61, i.e. at an average annual rate of about 15 per cent. This is no mean achievement.

Further, the only new progressive tax imposed during the first Plan was estate duty. It was levied by the Union in order to expand the development finance of the States. During the second Plan period, a number of brave new taxes was introduced to augment resources, improve equity and remove anomalies in the tax structure of India. The new direct taxes were capital gains (which was included in the sphere of income tax), annual wealth tax, personal expenditure tax and the general gift tax. In his Report Kaldor stated that 'India like
most Western countries has been in the grip of a vicious circle as far as progressive taxation is concerned - evasion and avoidance by cutting down potential revenue, led to higher nominal rates of taxation and this in turn to further evasion and avoidance and still higher rates. It is a vicious circle of charging more and more on less and less. The prime requirement is to break that vicious circle' (77). Mr.Krishnamachari laid the foundation to break this 'vicious circle' by making extensive alteration in the existing structure of taxes and by imposing new taxes. The substantial increase in the rates of taxation in the budget of 1957-58 is also reflected in the figures. Approximately, a sum of Rs.100 crores was proposed to be raised from additional taxes, 77 per cent of which were from indirect taxes and about 21 per cent from direct taxes. The effort to increase taxes also continued in subsequent years. However, inspite of these efforts so far there has been no fundamental change in the tax structure of the country. Even after one decade of planning, we are among the most lightly taxed people of the world. If we correlate the tax receipts with national income, we find that there has been a significant rise in tax receipts in absolute terms and to a less significant extent, in terms of the proportion of income taken by taxation.

(77) Indian Tax Reform, p.5.
TABLE VI - 1
National Income and Tax Receipts
(At current prices)

<table>
<thead>
<tr>
<th>Year</th>
<th>National income (In millions of Rs.)</th>
<th>Total Central &amp; State tax receipts (In millions of Rs.)</th>
<th>Percentage of tax receipts to national income.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951-52</td>
<td>99,700</td>
<td>7,387</td>
<td>7.4</td>
</tr>
<tr>
<td>1952-53</td>
<td>98,200</td>
<td>6,778</td>
<td>6.9</td>
</tr>
<tr>
<td>1953-54</td>
<td>104,800</td>
<td>6,723</td>
<td>6.4</td>
</tr>
<tr>
<td>1954-55</td>
<td>96,100</td>
<td>7,204</td>
<td>7.5</td>
</tr>
<tr>
<td>1955-56</td>
<td>99,800</td>
<td>7,675</td>
<td>7.7</td>
</tr>
<tr>
<td>1956-57</td>
<td>113,100</td>
<td>8,917</td>
<td>7.9</td>
</tr>
<tr>
<td>1957-58</td>
<td>113,900</td>
<td>10,476</td>
<td>9.2</td>
</tr>
<tr>
<td>1958-59</td>
<td>126,000</td>
<td>10,898</td>
<td>8.6</td>
</tr>
<tr>
<td>1959-60</td>
<td>128,400</td>
<td>12,199</td>
<td>9.5</td>
</tr>
<tr>
<td>1960-61</td>
<td>145,000</td>
<td>12,911</td>
<td>8.9</td>
</tr>
</tbody>
</table>

But if we compare with other advanced countries, the rate of growth does not seem to have been satisfactory. In some of the advanced countries, the proportion of tax receipts to national income is about 30 per cent or more than three times the reached in India at the end of the first decade of the Plan. The proportion of national income that we pay in taxes is low even compared with that of some other poor countries of Asia and Africa. Moreover, there is no consistency in the growth of tax receipts. The figures show that there are spurts in some years and comparative stagnancy or actual falls in other years. This means that the tax system has not been sufficiently elastic to meet the needs of economic development.
The brave new progressive taxes introduced during the planning period have practically become ineffective due to poor administration and liberal exemptions. The following table shows that the new taxes which came with a bang, ended in a whimper.

**TABLE VI - 2**

( In million Rs.)

<table>
<thead>
<tr>
<th>Year</th>
<th>Estate duty</th>
<th>Expenditure tax.</th>
<th>Tax on Wealth</th>
<th>Gift Tax</th>
<th>Total.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1956-57</td>
<td>21.1</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
<td>21.1</td>
</tr>
<tr>
<td>1957-58</td>
<td>23.1</td>
<td>Nil</td>
<td>70.4</td>
<td>Nil</td>
<td>93.5</td>
</tr>
<tr>
<td>1958-59</td>
<td>27.0</td>
<td>6.4</td>
<td>96.7</td>
<td>9.8</td>
<td>139.9</td>
</tr>
<tr>
<td>1959-60</td>
<td>29.1</td>
<td>7.9</td>
<td>121.1</td>
<td>8.1</td>
<td>166.2</td>
</tr>
<tr>
<td>1960-61</td>
<td>30.0</td>
<td>9.1</td>
<td>81.5*</td>
<td>8.9</td>
<td>129.5</td>
</tr>
</tbody>
</table>

* The reduction in the tax yield of wealth tax in 1960-61 was due to abolition of wealth tax on companies in that year.

In a country where income from property constitutes more than 25 per cent of national income, the wealth tax produced in 1960-61 a sum that came to only 0.05 per cent of national income. The total yield of the wealth tax, the expenditure tax, the estate duty and the gift tax amounted to only 0.08 per cent of national income in that year. While it is true that the rates of levy applying to high incomes are steep, this seems to have resulted only in high marginal propensity to evade taxes (78).

Sri Sahota has made a detailed study of the elasticity and buoyancy of the Indian tax system and its principal components over the period 1948-49 to 1957-58 (79). According to him, the response of the tax system to increase in national income can be

classified under two broad heads. One is the extent to which
the tax system gives an increased return with every increase in
the national income without any change in either the tax base or
the rates of existing taxes or the addition of new taxes. This
is what Sri Sahota calls the built-in inflexibility of the tax
system, the proportion of the rate of increase in tax yield to
that of the increase in national income (or a given sector of
the national income in the case of specific taxes) being termed
the elasticity of the tax system. The other category of increase
in tax yield is the result of changes in the rates and structure
of the tax system, involving its widening and deepening by way
of extension of base, additions to the number of taxes, and
increase in the rates of taxation. The two categories taken
together account for the total increase that takes place in tax
receipts; when linked to every increase in national income, that
is called by the author the buoyancy of the tax system. The rate
of buoyancy is calculated as the proportion of the rate of
increase in gross tax receipts to that of increase in national
income.

A major finding of his study is the low degree of
elasticity shown by the Indian tax system during the period
1951-52 to 1957-58. Thus, the overall elasticity of Union taxes
taken together is only 0.613, while that of Union and State
taxes taken together is only 0.833. In other words, a one per cent
increase in national income brings about only 0.833 per cent
increase in Central and State tax yields taken together, and only
0.613 per cent in Central tax yields taken separately. This
shows that the tax system is not efficient in India. As Dr.Rao
in his introduction to this study points out, 'An efficient tax
system ought to give better results; and if it is progressive,
it should possess an elasticity greater than unity. This is
particularly necessary in the case of an underdeveloped economy that is seeking to raise its rate of saving and investment and has, therefore, necessarily to rely on getting a larger share of incremental incomes for this purpose.

The composition of tax receipts further reveals the weakness of the Indian tax structure.

**TABLE VI - 3**

**Composition of Tax Receipts**

<table>
<thead>
<tr>
<th>(In million Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951 - 52</td>
</tr>
<tr>
<td><strong>Taxes on</strong></td>
</tr>
<tr>
<td><strong>Income and</strong></td>
</tr>
<tr>
<td><strong>Property.</strong></td>
</tr>
<tr>
<td><strong>Commodities &amp;</strong></td>
</tr>
<tr>
<td><strong>Services.</strong></td>
</tr>
<tr>
<td><strong>Transactions</strong></td>
</tr>
<tr>
<td><strong>Others</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

The table shows that over the last decade there has actually been a decline in the importance of direct taxation in our tax structure. Taxes on income and property contributed 32.6 per cent of our total tax receipts in 1951-52: the percentage has gone down to 29.5 in 1960-61.

The declining importance of direct taxation in the financing of public expenditure on economic development is borne out more clearly when we look at the growth of the income assessed to income tax and compare it with the growth of the direct taxes paid by them, both as a proportion of national income (80).

<table>
<thead>
<tr>
<th>Year</th>
<th>National income</th>
<th>Income assessed to income tax</th>
<th>Receipts from income tax</th>
<th>% of Col.3 to Col.2</th>
<th>% of Col.4 to Col.2</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951-52</td>
<td>99700</td>
<td>7829</td>
<td>1959</td>
<td>7.9</td>
<td>1.96</td>
</tr>
<tr>
<td>1952-53</td>
<td>98200</td>
<td>7116</td>
<td>1996</td>
<td>7.2</td>
<td>2.03</td>
</tr>
<tr>
<td>1953-54</td>
<td>104800</td>
<td>7813</td>
<td>1904</td>
<td>7.5</td>
<td>1.82</td>
</tr>
<tr>
<td>1954-55</td>
<td>96100</td>
<td>7600</td>
<td>1775</td>
<td>7.9</td>
<td>1.85</td>
</tr>
<tr>
<td>1955-56</td>
<td>98800</td>
<td>7849</td>
<td>1819</td>
<td>7.9</td>
<td>1.84</td>
</tr>
<tr>
<td>1956-57</td>
<td>113100</td>
<td>9357</td>
<td>2166</td>
<td>8.3</td>
<td>2.00</td>
</tr>
<tr>
<td>1957-58</td>
<td>113900</td>
<td>10105</td>
<td>2222</td>
<td>8.9</td>
<td>1.95</td>
</tr>
<tr>
<td>1958-59</td>
<td>126000</td>
<td>11727</td>
<td>2538</td>
<td>9.3</td>
<td>2.01</td>
</tr>
<tr>
<td>1959-60</td>
<td>128400</td>
<td>11921</td>
<td>2301</td>
<td>9.3</td>
<td>1.79</td>
</tr>
<tr>
<td>1960-61</td>
<td>145000</td>
<td>N.A.</td>
<td>2650</td>
<td>N.A.</td>
<td>1.83</td>
</tr>
</tbody>
</table>

The table shows that income assessed to income tax has grown as a proportion of national income; but the income tax it pays has actually declined as a proportion of national income. The total of all direct taxes paid by income tax assesses came to 1.96 per cent of the national income in 1951-52 and 1.79 in 1959-60 while the proportion of national income received by this class rose from 7.9 per cent to 9.3 percent in that period. Even if we take into account the new direct taxes on income and property levied during the second Plan period, the position remains virtually the same.

Another set of interesting figures show that while the share of the individual assesses among the income-tax-paying
class in national income has been rising over the nine years
ending 1959-60, the proportion of their income paid as tax
has been declining over the same period.

<table>
<thead>
<tr>
<th>Year</th>
<th>Assessed income</th>
<th>Tax</th>
<th>Income as a proportion of national income</th>
<th>Tax as a proportion of assessed income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951-52</td>
<td>4755</td>
<td>803</td>
<td>4.77</td>
<td>16.9</td>
</tr>
<tr>
<td>1952-53</td>
<td>4257</td>
<td>775</td>
<td>4.34</td>
<td>18.2</td>
</tr>
<tr>
<td>1953-54</td>
<td>4704</td>
<td>752</td>
<td>4.49</td>
<td>16.00</td>
</tr>
<tr>
<td>1954-55</td>
<td>4693</td>
<td>730</td>
<td>4.85</td>
<td>15.6</td>
</tr>
<tr>
<td>1955-56</td>
<td>5005</td>
<td>794</td>
<td>5.01</td>
<td>15.9</td>
</tr>
<tr>
<td>1956-57</td>
<td>5548</td>
<td>876</td>
<td>4.88</td>
<td>15.9</td>
</tr>
<tr>
<td>1957-58</td>
<td>6050</td>
<td>903</td>
<td>5.78</td>
<td>14.9</td>
</tr>
<tr>
<td>1958-59</td>
<td>6924</td>
<td>942</td>
<td>5.49</td>
<td>13.6</td>
</tr>
<tr>
<td>1959-60</td>
<td>7422</td>
<td>965</td>
<td>5.78</td>
<td>13.0</td>
</tr>
</tbody>
</table>

The table shows that individuals paying income tax
increased their share of the national income from 4.77 per cent
in 1951-52 to 5.78 per cent in 1959-60, while the proportion
of their income paid as tax declined from 16.9 per cent to
13 per cent during the same period. This means that taxation
did not adversely affect the economic position of individual
income tax payers as a class vis-a-vis the rest of the community.

Sri Sahota's study also shows that direct taxes have a
smaller elasticity as compared with indirect taxes. For example,
the income elasticity of the premier direct tax-viz. income tax
(forming 16 per cent of total tax revenue) is only 0.565 while
the income-elasticity of central excises (the premier indirect
Corporation tax as related to national income has a higher elasticity than income tax, being 1.25 but this is less than the central excises duties and the motor vehicle tax. Direct taxes have an elasticity of 0.674 in relation to urban income; the corresponding figure for indirect taxes is higher being at 1.065. Taking a weighted average of the elasticities of the top three direct taxes (which account for 21.7 per cent of total tax receipts) and the top two indirect taxes (accounting for 29 per cent of total tax receipts) and relating them to the national income as a whole, the author gets a weighted income-elasticity of these direct taxes and indirect taxes of 0.73 and 1.63 respectively. The author, therefore, remarks, 'Our supposedly progressive (direct) taxes are in fact regressive with an elasticity of 0.7 only; while our conventionally regressive (indirect) taxes are, in effect, progressive with an elasticity of 1.6' (81).

The buoyancy of taxes in India also shows the same tendency. In particular the following results are significant for policy matters: (82).

(i) Buoyancy of the income tax is 2.04.
(ii) Buoyancy of the central excise duties is 3.786.
(iii) Buoyancy of the most lucrative (major) component of the premier direct tax, viz. income tax from professional and business income group is 3.27.
(iv) Buoyancy of the most lucrative (major) component of the premier indirect tax head, viz. certain excise duties is 4.06.
(v) The buoyancy of the only progressive tax for the agricultural sector, namely agricultural income tax is no more than 1.756.

(81 Indian Tax structure and Economic Development, op.cit. p.16.
Ibid 20-21.)
All this indicates that the tax system in India is neither elastic nor progressive. While it is widely admitted that additional taxation is a part of the calculated sacrifice that will have to be paid for economic development, tax as a proportion of national income continues to be low even compared with poor countries of Asia and Africa.

Another important defect of the Indian tax system is that the agricultural sector which contributes more than 50 percent of the total national income pays in taxes only a mere fraction of its income. The following table shows the relation of tax revenue to national income in different sectors (83).

**TABLE VI - 6**

Tax Revenue and National Income.

( Rs. crores )

<table>
<thead>
<tr>
<th></th>
<th>1950-51</th>
<th>1959-60</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Agricul-</td>
<td>Non-agri-</td>
</tr>
<tr>
<td>National income (at current prices).</td>
<td>tural sector</td>
<td>cultural sector</td>
</tr>
<tr>
<td>Tax Revenue.</td>
<td>5095</td>
<td>4435</td>
</tr>
<tr>
<td>Direct Taxes.</td>
<td>56</td>
<td>173</td>
</tr>
<tr>
<td>Indirect Taxes.</td>
<td>165</td>
<td>234</td>
</tr>
<tr>
<td>Total</td>
<td>221</td>
<td>407</td>
</tr>
</tbody>
</table>

Sectoral tax revenue as percent of total tax receipts.

<table>
<thead>
<tr>
<th></th>
<th>1950-51</th>
<th>1959-60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax revenue as percent of national income from the particular sector.</td>
<td>35</td>
<td>65</td>
</tr>
</tbody>
</table>

The table shows that while agriculture accounts for about half of the national income, its share in tax revenue is at present only a little over a quarter of the total. On the other hand, the share of the non-agricultural sector in total tax revenue is 74 per cent. Again, tax revenue as a percentage of national income from the agricultural sector is comparatively very low, only 5 per cent whereas it is 14 percent in non-agricultural sector. Moreover, between 1950-51 and 1959-60 while the increase in tax revenue in the non-agricultural sector amounted to 25 per cent of the increase in income at current prices in this sector the increase in tax revenue in the agricultural sector was only 6 per cent of the increase in income in this sector (84).

The greatest disparity is to be seen in the upper-income groups (those earning Rs.3000 - 3600 per annum or above) in both the sectors which are the most relevent groups for purposes of additional taxation. The tax-payment of this group in the agricultural sector is estimated below in table VI-7 (85).

<table>
<thead>
<tr>
<th>TABLE VI-7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax paid by the Agricultural Upper Income Group.</td>
</tr>
<tr>
<td>( Rs. crores )</td>
</tr>
<tr>
<td>1953-54</td>
</tr>
<tr>
<td>Land Revenue</td>
</tr>
<tr>
<td>Agricultural income tax.</td>
</tr>
<tr>
<td>Estate duty ( State )</td>
</tr>
<tr>
<td>Indirect taxes.</td>
</tr>
<tr>
<td>Total tax Receipts .</td>
</tr>
<tr>
<td>Total income of this group.</td>
</tr>
<tr>
<td>Tax revenue as per cent of total income of this group.</td>
</tr>
</tbody>
</table>

(84) Ibid, p.1831.
(85) Tax Payer Psychosis in India, op. cit. p. 449.
The tax payment of the non-agricultural upper-income group is estimated below in Table VI - 8.

**TABLE VI - 8**

<table>
<thead>
<tr>
<th></th>
<th>1953-54</th>
<th>1959-60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax</td>
<td>75.2</td>
<td>96.5</td>
</tr>
<tr>
<td>Expenditure tax</td>
<td>-</td>
<td>0.8</td>
</tr>
<tr>
<td>Tax on Wealth</td>
<td>-</td>
<td>12.1</td>
</tr>
<tr>
<td>Gift Tax</td>
<td>-</td>
<td>0.8</td>
</tr>
<tr>
<td>Indirect Taxes</td>
<td>34.6</td>
<td>53.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>109.8</td>
<td>163.6</td>
</tr>
<tr>
<td>Tax revenue as per cent of total income of this group.</td>
<td>23.0</td>
<td>22.0</td>
</tr>
</tbody>
</table>

Source: Agriculture Inadequately Taxed, op. cit.

A comparison between Tables VI - 7 and VI - 8 shows that while the non-agricultural upper income group pays about 22 per cent of its income in taxes, the corresponding percentage for the agricultural upper income group is only about 8.6 per cent.

The above analysis indicates that there is a great need for improvement in the Indian tax structure to realise resources for economic development and to remove anomalies that now exist in different fields of taxation. The following important changes may be suggested to improve the tax structure of India.

**Suggestions for Improvement:**

1. **Non-agricultural Direct Tax.**

   Income tax is one of the most important non-agricultural direct taxes in India. But its yield is not sufficiently elastic. Thus while in the U.S.A., roughly a one percent increase in personal income causes nearly 2 per cent increase in personal
income tax, and while in the U.K., income tax yields have been substantially increasing during the past few years inspite of frequent reductions in tax rates by the Conservative government, in India despite continual increases in rates and coverage and intensified collection campaigns, gross income-tax receipts have increased only at 0.6 per cent per annum as against a rise of 2.2 per cent per annum in national income and 3.5 per cent per annum in incomes arising in the urban sector, since 1951-52. The elasticity of income tax in relation to urban income is only 0.335 (86).

What should be done to raise additional revenue from income tax? There is no scope for increasing rates to high incomes. That the marginal rates applying to high incomes are very high is indisputable. These high rates lead to large-scale evasion. Tax evasion is one of our more profitable enterprises in which much of our legal talent, business organisation and executive dexterity are invested. If the high incomes are given some relief at the margin, there might be some weakening of the urge to avoid and evade taxation - an urge which should normally be very strong in view of the fact that the gains from successful evasion are very large at these high levels of income (87).

But there is ample scope for improving upon the tax rate structure in India which is characterised by extremely low rates on lower and middle income brackets. Dr. Gulati has given detailed comparisons in tax rates between India and some other countries at income levels between Rs.3000 to Rs.20,000 per annum. His study shows that this group is most lightly taxed (86) Indian Tax Structure and Economic Development, op.cit.p.43. (87) I.S. Gulati : Resource Prospects of the Third Five Year Plan, Orient Longmans 1960, p.82.
under Indian income tax system compared with corresponding income group in some other countries. Take for example, an individual in India with wife and two children earning ₹12,000 a year. He is more than eight times better off than the average Indian family. A Japanese with equivalent income is only three times better off than an average family of his country while an Englishman and Dutchman similarly placed are a little below their national average levels: but the income tax payable at this income is ₹637 in India (i.e. at the rate of 5.3 per cent), ₹2,067.3 in Japan (i.e. 17.2 per cent), ₹1450 in Holland (i.e. 12 per cent) and ₹703 (i.e. 5.8 per cent) in the United Kingdom (88).

This is just one example. The disparity between the direct taxation of incomes in India and the countries referred to above continues from ₹3,000 to ₹20,000 and then begins narrowing at a fast rate as income exceeds ₹20,000. The reason for the low incidence on incomes up to ₹20,000 is that the Indian rate-schedule begins with a very low rate. The range of progression of the Indian income tax is 3 per cent to 87 per cent as compared to 10 per cent to 70 per cent in Japan, 8.75 per cent to 88.75 per cent in the U.K., 9 per cent to 80 per cent in West Germany and 20 per cent to 92 per cent in the U.S.A. (89).

This suggests that there is scope for narrowing down the range of progression. If the rates applying to lower slabs are increased and the rates at upper slabs are slightly reduced, additional yield of income tax can be secured without increasing the tendency to evasion. If the rates applying to lower groups

88 bid, pp. 84-85.
(89) Ibid, p.87.
of slabs are increased, this will raise the incidence not only on the incomes falling in the slabs actually affected but also on the incomes in the higher slabs because the latter also will have to pay more tax on that portion which falls in the earlier slabs. If high rates of income tax on upper income groups are reducing incentives, reduction in rates will restore incentives and thus lead to the creation of larger incomes. In that case, receipts of the government from income tax would also be higher than before.

The other important non-agricultural direct tax is corporation tax. With the expansion of business activity, its importance is increasing year by year. From about Rs. 40.49 crores in 1950-51, the corporation tax has now come to Rs. 178.50 crores in 1962-63 (B.E.). We have already seen that this tax is more income-elastic than income tax. Yet this tax also has not shown the responsiveness which it should have. For example, during the 7 years from 1951-52 to 1957-58 while industrial profits increased by 7.9 per cent per annum, value added by manufacture increased by 6.6 per cent per annum and income arising in urban sector increased by 3.3 per cent per annum, yields from corporation tax, exclusive of effects of changes in rates and coverage, increased hardly at a rate of one per cent per annum (90). Since the profit is the base of corporation tax and profit during this period has expanded much more rapidly than average income, the yield of corporation tax should have expanded increasingly in terms of national income.

What is needed, therefore, is to reduce or withdraw some of the concessions which the tax laws in this country give and which, either are more liberal than is justified or have outlived (90) Indian Tax Structure and Economic Development, op. cit. p. 51.
the purposes they were intended to serve originally when they were first introduced. The grant of development rebates on outlay on new plant, machinery and ships or the grant of tax holiday to new manufacturing concerns and hotels is no longer necessary. A development rebate at the rate of 25 per cent of the cost of new plant and machinery installed after the 31st March 1954 was allowed as a deduction for computing the taxable profits of a business. The rate of development rebate in the case of China was fixed at 40 per cent of the cost of the ships. In 1961-62, the development rebate was reduced to 20 per cent in case of machinery or plant installed after March 31, 1961. Since private business in India is doing well and making rather high profits, there is no need for continuing such rebates.

Similarly new industrial undertakings are now given the benefit of the 5 years' tax holiday under the section 15 c of the Income Tax Act. In the budget of 1961, this benefit was extended to newly started hotels which satisfied certain conditions so as to promote tourist traffic in the country. The government expenditure on economic and social overheads is improving opportunities for the establishment of new firms and the promotion of old firms. There is no need to provide special concessions for this purpose. Encouragement of tourist traffic at a time when there is heavy congestion in our trains and buses is not desirable. If some of these concessions are removed, the corporation tax may be more income-elastic than what is today. During the last few years, a number of changes has been introduced in the corporation tax to simplify it. The rate of tax has also increased from 45 to 50 per cent in case of Indian companies in 1962-63 (budget). These changes are likely to increase the yield of corporation tax.
The other direct tax which needs reform is wealth tax. The wealth tax is not now an important source of revenue in the country. It may not probably be an important tax gatherer as long as it is imposed only on capital and not on property including agricultural property. But the more important consideration in favour of the wealth tax at the present time in case of the Union is that through its imposition the authorities get information which enables them to exercise a more effective check on the returns of income submitted to them in connection with the assessment of income tax (91). If that is so, there is a need to reduce the exemption limit of the wealth tax. Now individuals with net wealth amounting to Rs. 2 lakhs and less and Hindu undivided families with net wealth amounting to Rs. 4 lakhs and less are completely exempted from the wealth tax. If wealth tax is to play the corrective role referred to above, the exemption limit will have to be lowered suitably so that the increased rates of income tax are applied as effectively as possible right from the first taxable slab upwards. Dr. Gulati, therefore, suggests that the exemption limit of wealth tax should be lowered as a first step to Rs. 50,000 then to Rs. 30,000 and finally to Rs. 20,000 so that evasion of income tax in case of middle income groups can be suitably checked (92).

(2) Agricultural Taxation:

We have already seen that agriculture is inadequately taxed in India. The following measures should be taken to increase the tax burden in agriculture.

(1) Land revenue: The importance of land revenue has declined in recent years. Though there has been more than a four-fold rise in agricultural prices since 1939, land revenue rates fixed at depression and pre-depression prices have remained

is an increase in income, expenditure on food increases more than proportionately. This increases the price of food materials, but due to low elasticity of supply of agriculture, there is no significant increase in agricultural output. As a result, the income of agricultural population increases along with more consumption of food. This reduces the supply of food to non-agricultural sector and intensifies the rise in price in all sectors.

Thirdly, a part of the increased income is diverted to imports. The marginal propensity to import is high in many of these countries. Increased imports cannot easily be offset by increased exports due to lack of diversification in the economy. This will, therefore, create a balance of payment difficulty. If import restrictions are used to correct adverse balance of payments, there may be excessive pressure on domestic supplies leading to greater rise in prices.

Fourthly, the character of economic development may also accentuate inflationary tendencies. The underdeveloped countries require greater investment in capital goods and economic and social overhead capital to accelerate the process of development. These developmental programmes generate increasing purchasing power in the country without creating proper machinery for supplying adequate amount of consumer goods. The marginal propensity to consume in poor countries being very high, the effect of large investment shows inevitably of a general rise in price level. The emphasis of welfare in economic development also increases the bias towards social and developmental services in public expenditure and thus aggravates inflationary troubles.
Finally, the low capacity of underdeveloped economies to shift resources from one use to another or from one sector to another i.e. resource immobility increases the chances of price rise due to deficit spending. Though immobility of resources contributes to low elasticity of supplies it is a distinct feature of underdeveloped economy. (30). Because, low elasticity of supply refers to the difficulty of increasing supplies of given factors from the resources already committed to it. Immobility of resources on the other hand, refers to the difficulty of augmenting resources committed to one sector by reducing resources committed to another. In a developed economy with a large stock of capital, resource mobility is to some extent provided by the depreciation of capital. In a growing economy resource mobility is facilitated by the fact that it is easier to change the allocation of new resources than to change the distribution of resources already committed. An underdeveloped economy has neither much capital to depreciate, nor a large volume of fresh resource for differential rates of growth (31). The fact of the matter is that the capacity to shift resources depends on the capacity to increase income. Since underdeveloped countries lack these forces, deficit financing has a tendency to lead to inflation.

The above analysis shows that the circumstances in underdeveloped countries are such that large scale deficit spending may create 'true inflation', to use the term of 'General Theory', long before full employment is reached or

(31) Ibid, p.93.
'even without*, any appreciable increase in employment'. This is not so with regard to developed countries. In case of the latter, 'so long as there is unemployment, employment will change in the same proportion as the quantity of money; and when there is full employment, prices will change in the same proportion as the quantity of money' (32). Even when there is full employment, increased spending may not raise prices if the economic system has linear cost functions (33).

The impact of deficit financing on price level in developed and underdeveloped countries is presented in the diagram No. V - 1.

Diagram No. V - 1 shows that deficit spending raises price level in underdeveloped countries much more steeply than in developed countries. That means, deficit spending as a means of raising resources for development purposes in underdeveloped countries cannot be extended to a considerable extent without creating inflationary forces in the economy.

**Inflation and economic development:**

If deficit financing is likely to lead to inflation, what then is the effect of inflation on economic development? Opinion in this field is sharply divided. Some are violently opposed to inflationary method of finance, others strongly support it. Schumpeter for example, built a powerful case for inflationary method of finance (34). According to him, the entrepreneur who plays a dominant role in the process of

(33) Hansen assumes that cost functions will continue to be linear even after full employment. See Monetary Theory and Fiscal policy, op. cit. pp. 107-110.
Diag No. V-1

Relation between Deficit Spending and Price Level

ΔD < ΔP

ΔD > ΔP

P = F(c.l.i.)

P₁

P₂

Full Employment

Under Developed Countries

Under Capacity

D₁

D₂

D
development, can finance development only by credit creation and not from savings out of current income. This view is different from classical or neo-classical analysis which is based on real terms. Schumpeter's model is a theoretical one. Hamilton on the other hand shows that historically inflation was a powerful promoter of industrial growth during the period of industrial revolution (35). According to him, during long periods of inflation, rising prices tended to outrun compensating wage adjustments. The result was profit inflation. Profit thus secured was ploughed back into capital formation. Thus profit inflation enabled a much more rapid rate of industrial growth to occur than would have obtained under stable prices. Keynes also endorses Hamilton's thesis. On the other hand Felix points out, with the help of a large mass of empirical data that profit inflation has not always stimulated industrial development (36).

However, it is inevitable that when other methods of financing are inadequate, there should be inflationary methods of finance to expedite capital formation and economic development. It is probably not possible to have rapid economic development without some inflation. Inflation has some use in the sense that it will raise prices and facilitate transfer of resources from non-savers to savers and increase the size of total capital accumulation. If the government is the investor, inflation may be able to mobilise potential resources and thus increase the economic development of the country. If capital


equipment could somehow be found to employ some of the unemployed, and if new money were then created to pay their wages in producing consumer goods, then these workers would save part of their incomes, and their savings could be used to pay additional workers to produce capital works (37).

Deficit financing in this sense is different from war time experiences. Deficit financing during a period of war withdraws goods for destructive purposes and in such a situation inflation becomes cumulatively worse, since 'an ever-increasing supply of money may, face an ever-dwindling supply of goods'. But inflation used for the purpose of creating useful capital is likely to be self-destructive, since it ultimately results in an increasing supply of goods.

Moreover, in a developing economy, an increase in the quantity of money is, as already discussed necessary to meet the demands of the increased rate of output. Without an increase in the quantity of money, prices may even fall and create deflationary tendencies in the economy. If this be the case, then it behoves us, as Vickrey says, to broaden our horizons and admit a condition of specified,controlled, and generally anticipated inflation as a respectable and possibly even desirable condition, rather than to view inflation as being necessarily the result of fiscal immorality (38).

An increased quantity of money is also necessary to monetise the non-monetised sector. The monetisation of the economy will increase the demand for cash balances in place of real savings and induce people to save more than what they were doing previously. Some inflation may also be helpful in diverting resources from the non-market source to the market economy. According to Schatz, the existence of non-market source of resources for the market economy makes inflation self-correcting by inducing a greater entry of resources from the non-market economy to the market economy which in fact has the effect of increasing production and hastening development (39).

This shows that in a stagnant economy, inflation has some salutary effect in accelerating the process of growth.

(39) S.P. Schatz: Inflation in Underdeveloped Areas: A Theoretical Analysis, American Economic Review, September 1957. However, this source of finance does not seem to be large. There is a fundamental difference between increase in productivity and diversion of resources from the non-monetised sector to the monetised sector. The former not only increases marginal propensity to save, it also creates necessary conditions for economic growth. The latter may increase the marginal propensity to consume of the non-monetised sector and thus reduce the marketable surplus for the monetised sector. See S. K. Ghosh: Inflation in an Under-developed Economy, World Press 1959, p. 22.
However, too much should not be expected of inflation. Its success will depend upon two important factors:

(1) The magnitude of transfer of real resources through inflation.

(2) Effect on Productive Investment.

With regard to the magnitude of transfer of real resources, it is doubtful whether sufficient amount of real savings can be increased by means of inflation. According to the calculation of Bernstein, whereas under fairly stable monetary conditions, the savings and net investment in an underdeveloped country might amount to, say 6 per cent of the national income, under inflationary conditions, even with the increased savings out of profits, the savings and net investment might not exceed, say 8 per cent of the national income (40). But the extent to which prices would rise to divert resources from wage earners to profit earners to the extent of 2 per cent, would depend upon the ratio of wages to profits in national income. The larger the labour's relative share of the national income, the smaller will be necessary price rise

to achieve any given percentage increase in the relative shares of savings in the national income, because a given shift in real income will be from a larger base and will, therefore, require a smaller percentage of price rise for the shift to occur. Since in underdeveloped countries, the ratio of wages to profits in national income is low as is shown later, a larger price inflation would be necessary to increase a small rate of savings (41). The social cost of inflation to increase a small rate of investment would, therefore, be high in these countries.

Inflation has also a tendency to reduce voluntary savings since it does not pay to hold savings in the form of money assets during a period of inflation. It also places a premium on 'improvidence and careless spending' and thus reduces the saving habit of the people. The reduction of real income is another contributing factor. It follows that if reduction in voluntary savings is equivalent to savings out of profits, there is no net increase in investment due to inflation. There is only a shift in the ownership of such investment from the general public to the profit receivers. In other words, the ownership of wealth becomes more concentrated (42).


(42) Bernstein op. cit. pp.287-289.
The wage-lag axiom constitutes the foundation of the theory of inflation for industrial development. With regard to developed countries, the wage-lag thesis does not seem to have great validity. Professors Kessel and Alchian show with the empirical examples of Spain, England, France, the U.S.A. and Germany that wages do not lag behind prices (43). If this is true, the whole logic of profit inflation seems to be doubtful. Due to the prevalence of unemployment and underemployment and pressure of population on land and other resources, temporary inflationary pressures may not set off wage-price spirals in underdeveloped economies. To the extent this is true, cut in real wages may induce profit inflation. But since in these countries, real wages are very low, consideration of social justice and of industrial efficiency would militate against a rise in cost of living without a corresponding adjustment of money wages. It is, therefore, doubtful whether a steep rise in price level would be permissible in poor economies.

Again, though the general public gives up consumption to the extent of some multiple of the amount of the investment financed by inflation, the business men may not

increase their saving in proportion to the increase in their income. Of the total shift of income to businessmen, about two thirds, according to Bernstein, have no other economic function that to be large enough to induce them to save one-third of the increase in their profits. Van Philips with the example of Mexico has shown that if entrepreneurs' income would rise by 9 per cent due to diversion of resources from the fixed income groups, their saving quota would increase by 3 per cent and further their investment quota by only 1 per cent. This means that the entrepreneurs consume two-thirds of the reduced consumption of the injured group, hoard two-ninths and invest only one-ninth (44).

Finally, if a policy of inflation is persistently followed to finance economic development, there might be a movement of capital from the home country to foreign countries. This shows that a fairly high degree of inflation is not only a hindrance to capital accumulation, but it may actually destroy the available capital resources.

(2) With regard to the effect of inflation on investment, there is also doubt whether inflation would encourage productive investment. Though government investment can be directed according to pre-arranged programmes, private

(44) Public Finance and Less Developed Economy, op. cit. p.159.
investment may not move on proper lines. Since private investment plays an important part in economic development, the adverse effect of inflation on this sector cannot be lost sight of. Actually inflation broadens the scope of profitable investment where 'the use benefits are low and ownership benefits are high'. Such types of investment are inventory accumulation, luxury urban construction, estate speculation and holding of foreign assets. This shows that inflation distorts the pattern of investment. Especially in countries which have a small industrial class, the tendency of speculation is likely to be much greater.

Inflation does not only misdirect savings, but also discourages investments having highest use benefits. The discouragement of export industries due to rise in internal prices and low-income consumption goods due to shift of income from lower-income groups to higher ones may actually retard economic growth (45). The worst feature of inflation

more or less unchanged and their real burden has been considerably lightened. Land tax now constitutes an almost insignificant proportion of the total cost of production in agriculture; it is no more than one percent of the gross value of agricultural output. The incidence of land revenue has thus ceased to be appreciable. Land revenue accounted for only 7 per cent of total tax revenue in 1956-57 and 6.5 per cent in 1959-60 as against 16 per cent in 1938-39. This downward movement in receipts from land revenue is mainly attributable to the failure to adjust land revenue to the rising price level. Therefore it is desirable to raise more from the land revenue than has been done so far. One way of doing so is to impose a surcharge on all holdings on the basis of changes in the price-level and the rise in agricultural output.

There is also scope to introduce some degree of progressiveness in land revenue. Dr. Gulati suggests the following rate structure to make land revenue progressive (93).

**TABLE VI - 9**

<table>
<thead>
<tr>
<th>Area of household holding</th>
<th>Rate of Land Revenue per acre</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 20 acres</td>
<td>2.50</td>
</tr>
<tr>
<td>Next 10 acres</td>
<td>5.00</td>
</tr>
<tr>
<td>Next 10 acres</td>
<td>7.50</td>
</tr>
<tr>
<td>Next 10 acres</td>
<td>10.00</td>
</tr>
<tr>
<td>Next 50 acres</td>
<td>15.00</td>
</tr>
<tr>
<td>Balance</td>
<td>25.00</td>
</tr>
</tbody>
</table>

According to his estimate, the additional receipts from the introduction of the proposed progression in land revenue are likely to amount to Rs.61.2 crores. Thus the introduction of the progressive rate schedule suggested above will not only serve the objective of e uit b narrowin down t d ce rospec s 0 e r P an, op.cit. p.73.
in tax incidence between agricultural and non-agricultural incomes but also raise the resources of the government.

The need for the introduction of progressive land revenue arises due to the ineffectiveness of agricultural income tax. From the point of view of effective application of a tax, there must be a tax base which is easy to locate and identify. In case of India, between income and land as two alternative bases for a tax, there could have been no question of a choice because the choice is so clearly in favour of land from the above point of view. Dr. Lakdawala rightly points out, 'In an underdeveloped country like India with smaller size of holdings, lower average incomes, greater self-sufficiency, and greater illiteracy, agricultural income tax can only be collected with some degree of efficiency from a very small minority of the rural population' (94).

It follows that if a progressive land revenue is introduced, the ineffectiveness of agricultural income tax can be done away with. Ultimately, there may not be any need for a separate agricultural income tax.

(ii) Betterment levies:

The necessity of betterment levies has already been discussed. When certain persons gain from a particular development project without their contributing directly towards the cost of the project, they ought to pay in terms of tax a part of the gain that accrues to them. In case of irrigation projects for example, many people who live by the side of the project derive direct and indirect benefit in the sense that there is both increase in the annual and capital value of their land. The improvement in

(94) D.T.Lakdawala, Taxation and the Plans, p.114.
capital value is a sort of unearned accretion which is considered ideally and legitimately taxable. (95).

But in imposing betterment levies, there should be some caution. All holdings do not derive the same benefit. Very likely large holdings are likely to take greater advantage of irrigation facility since they would be able to provide other complementary inputs that are necessary to increase the productivity of land. There is also the necessity that the lands provided with new irrigation facilities should be allowed a certain development period after the commencement of the supply of water. Otherwise there will be resistance to the tax. If there is a progressive betterment levy, as proposed by Dr. Gulati, on holdings about above 20 acres, with the rate rising from 50 per cent to 75 per cent of the increment in capital value and with a development period of 5 to 10 years, a new source can be tapped for the development of the economy.

(iii) Other taxes:

A number of other taxes is suggested to increase the share of agriculture in the total tax burden of the country. One such tax is Agricultural Wealth Tax. A tax on agricultural income may be avoided by not earning the income and allowing the resources to remain idle. But a wealth tax on land cannot be avoided as it would be assessed on the capital value of land and thus linked to its potential output. Since there is already wealth tax in India, there is sufficient justification to extend the tax to agricultural wealth. This tax may be made progressive on the total value of land owned by individuals with a necessary minimum of exemption. The Australian Commonwealth land tax is of this type. Such a tax may also help to bring about a more equal distribution of land, for a.

(95) Resource Prospects of the Third Five Year Plan, op. cit. p. 78.
big land holder by selling half of his land in terms of value, will escape more than half of his tax.

Dr. K. N. Raj makes suggestions for the imposition of two more new taxes, i.e. (a) a surcharge on holdings above five acres under commercial crops and (b) a tax on agricultural rent (96). There is a strong case for introducing a surcharge on commercial crops since they are more remunerative than food crops. But there is a danger that the surcharge may lead to substitution of crops and thus create difficulty for proper crop planning. However, if the rate is low and there is differentiation between different crops on the basis of profit, a surcharge will be a useful device to collect a part of the profit that accrues to farmers engaged in commercial cropping.

A tax on agricultural rent is justified from the point of view of equity. Rental incomes in India are estimated to be around Rs. 800 crores and a portion of this should by all means be tapped for economic development. But after land reforms, the rental incomes are likely to fall and this tax may not be of much revenue significance.

The crux of the problem is that agriculture is now inadequately taxed and there is need to revise the present method of land taxation and impose additional taxation so as to raise additional resources from agriculture.

(3) Taxes on commodities :

Though taxes on commodities have been increasing, there still exists considerable scope for securing sizeable additions to the government's revenue. There is no doubt that the burden of indirect taxes has increased in recent years, but in absolute

terms it has not been so heavy as to prevent further addition to existing taxes. The following figures are meaningful.

**TABLE VI - 10**

**Incidence of Indirect Taxes**

<table>
<thead>
<tr>
<th></th>
<th>1953-54</th>
<th>1958-59</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Indirect Taxes incidence (as percentage of consumer expenditure)</td>
<td>3.6</td>
<td>5.5</td>
</tr>
<tr>
<td>2. Central indirect taxes (as percentage of consumer expenditure)</td>
<td>2.2</td>
<td>3.8</td>
</tr>
<tr>
<td>3. State indirect taxes (as percentage of consumer expenditure)</td>
<td>1.4</td>
<td>1.7</td>
</tr>
<tr>
<td>4. Per capita income (current prices) (Rs.280)</td>
<td>(Rs.300 - 310)</td>
<td></td>
</tr>
<tr>
<td>Per capita income (1948-49 prices)</td>
<td>Rs.268</td>
<td>(Rs.290 - 295)</td>
</tr>
</tbody>
</table>


There is no doubt that between the two years the incidence has gone up in terms of the per capita income but in absolute terms the burden is still very small - Rs.9.7 in 1953-54 and Rs.15.7 in 1958-59, that is, an increase of Rs.6 compared with an income rise of Rs.20 - 30. This burden is not too heavy in a developing economy.

The effect of indirect taxes on consumer price index is an important consideration to determine the size of indirect taxes. In this connection, a recent study by the Planning Commission on the incidence of indirect taxes on the consumer price index is of considerable interest. The study shows that over the period 1950 - 59 the probable increase in the consumer price index due to changes in excise duties and sales tax has been of the order of about 4 to 5 points. This is illustrated
in Tables VI-11 and VI-12.

**TABLE VI-11**

Number of Points Increase in Consumer Price Index:
Actual Increase & Probable Increase
Due to Excise Levy.

(over the period 1950 - 59)

<table>
<thead>
<tr>
<th>City</th>
<th>Probable increase in consumer price index due to excise levy</th>
<th>Actual increase in consumer price index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bombay</td>
<td>Maximum 6 Minimum 4</td>
<td>31</td>
</tr>
<tr>
<td>Ahmedabad</td>
<td>Maximum 6 Minimum 4</td>
<td>20</td>
</tr>
<tr>
<td>Sholapur</td>
<td>Maximum 7 Minimum 4</td>
<td>18</td>
</tr>
<tr>
<td>Jalgaon</td>
<td>Maximum 6 Minimum 3</td>
<td>16</td>
</tr>
<tr>
<td>Jamshedpur</td>
<td>Maximum 7 Minimum 4</td>
<td>19</td>
</tr>
<tr>
<td>Gauhati</td>
<td>Maximum 7 Minimum 5</td>
<td>(-) 2</td>
</tr>
<tr>
<td>Jharia</td>
<td>Maximum 6 Minimum 4</td>
<td>(-) 5</td>
</tr>
<tr>
<td>Kharagpur</td>
<td>Maximum 6 Minimum 4</td>
<td>10</td>
</tr>
<tr>
<td>Delhi</td>
<td>Maximum 10 Minimum 6</td>
<td>20</td>
</tr>
<tr>
<td>Jabalpur</td>
<td>Maximum 10 Minimum 6</td>
<td>7</td>
</tr>
<tr>
<td>Madurai</td>
<td>Maximum 4 Minimum 2</td>
<td>18</td>
</tr>
</tbody>
</table>


It is seen from the above table that compared to the actual increase in consumer price indices the hypothetical increases in the price index due to excise levy worked out in columns 2 and 3 appear to be on the whole small. Similar conclusions may be drawn from the number of points change in consumer price index arising from the imposition of sales tax.


**TABLE VI - 12**

Number of Points Rise in Consumer Price Index
Due to Imposition of Sales Tax.
(over the period 1950-59)

<table>
<thead>
<tr>
<th>City</th>
<th>Rise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bombay</td>
<td>0.79</td>
</tr>
<tr>
<td>Ahmedabad</td>
<td>0.81</td>
</tr>
<tr>
<td>Sholapur</td>
<td>0.82</td>
</tr>
<tr>
<td>Jalgaon</td>
<td>0.80</td>
</tr>
<tr>
<td>Jamshedpur</td>
<td>0.51</td>
</tr>
<tr>
<td>Gauhati</td>
<td>3.22</td>
</tr>
<tr>
<td>Jharia</td>
<td>0.52</td>
</tr>
<tr>
<td>Kharagpur</td>
<td>0.44</td>
</tr>
<tr>
<td>Jabalpur</td>
<td>1.03</td>
</tr>
<tr>
<td>Madurai</td>
<td>1.37</td>
</tr>
</tbody>
</table>

It follows that there should be further addition to indirect tax to meet the development needs of the country. The revenue yielding capacity of indirect tax is so considerable and their administration is so simple that they cannot easily be avoided. Dr. Gopal thinks that an over-all increase of 10 percent in commodity taxes is feasible and even easy (97).

But what is necessary is that commodity taxes should be progressive. At present, there is more tax on wage goods than on luxuries. In this connection, the following table showing a commodity break down of Union excise duties, the most important indirect tax in India, is of some interest.

**TABLE VI - 13**

Excise Revenue by Groups of Commodities.

<table>
<thead>
<tr>
<th>Year</th>
<th>Wage-goods</th>
<th>Amenities &amp; Luxuries</th>
<th>Intermediate Materials and Miscellaneous</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1948-49</td>
<td>20.96</td>
<td>26.87</td>
<td>3.46</td>
<td>0.36</td>
</tr>
<tr>
<td>(Accounts)</td>
<td>(40.6%)</td>
<td>(52.0%)</td>
<td>(6.70%)</td>
<td>(0.70%)</td>
</tr>
<tr>
<td>1960-61</td>
<td>159.11</td>
<td>108.49</td>
<td>120.10</td>
<td>11.78</td>
</tr>
<tr>
<td>(Revised)</td>
<td>(39.8%)</td>
<td>(27.2%)</td>
<td>(30.1%)</td>
<td>(2.9%)</td>
</tr>
</tbody>
</table>

(2) Indirect Taxes - Retrospect and Prospects, Tata Quarterly, October, 1959.

(97) M.H.Gopal : A Realistic Tax Structure for India, op.cit.
The table shows that while the proportion of duties on 'wage-goods' to total central excises has remained at about 40 per cent, of those on 'amenities and luxuries' has declined from 52 per cent in 1948-49 to 27.2 per cent in 1960-61. That means, poor people have been hit hard by excise duties. This state of affairs has to be changed and there should be more taxes on luxuries to introduce an element of progression in indirect taxes.

There is also a need to revise prohibition policy. Taxes on liquor and other intoxicants are excellent from the standpoint of both productivity and equity. Present policy only succeeds in replacing licit by illicit consumption. Moreover, illicit distillation being carried on under highly unhygienic conditions produces more harmful effects on those who continue to indulge in drink. In view of the fact that administrative machinery is not well-equipped to enforce prohibition, it is better to enhance excise duty, control the consumption of liquor and other intoxicants and realise more revenue for economic development. It is estimated that the States in India have lost about $120 crores in the first five year Plan period as a result of prohibition policy, not taking account of the extra enforcement costs. If important resources are frittered away for no better reason than political fads and fancies, we will do immense harm to the economy.

The upshot of the analysis is that there is considerable scope to improve the tax structure of India to meet the cost of development.