Chapter I

Introduction and Research Plan
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Significance of the Study

Mounting needs of public expenditure exert constant pressure on modern Governments to explore ways and means of mobilizing more and more revenue from tax as well as non-tax resources. Since debt financing has severe limitations, Governments have placed greater reliance on tax revenue and depended largely on taxes like the corporation income-tax, to meet their increasing requirement of funds. Today, the corporation income-tax forms one of the most prominent forms of direct taxation all over the world and contributes significantly to the public exchequers of nations -rich or poor, developed or developing.

In India, corporations have been treated as separately taxable entities and incomes earned by them have been subjected to taxation ever since 1860. This distinct treatment of corporate incomes has been maintained through the various direct tax legislations enacted in 1886, 1918, 1922 and 1961. The same principle is sought to be continued in the proposed Income-Tax Act of 1998, a draft working bill of which has been submitted recently to the Government.¹

The importance of corporation income-tax in the overall scheme of direct taxation in the country has increased over the years. It has replaced the personal income-tax as the largest single component of all direct taxes. In 1994-95, the revenue contribution from corporation income-tax was Rs. 13,821 crore, which

represented 1.6 per cent of the Gross Domestic Product and about 51 per cent of all direct taxes collected in the country.

Reform of direct taxes has received serious attention of successive Indian Governments in the post-independence period. This is evidenced by the number of Study Groups, Tax Reforms Committees and High Powered Enquiry Commissions appointed by the Government to study the structure of these taxes and to recommend suitable policy and administrative measures aimed at improving the overall tax collections and compliance. The major objectives of tax reforms have been to rationalize the system of direct taxes, remove its anomalies, make the tax system fairer and broad based, improve equity, sustain economic incentives, improve the income elasticity of tax revenue, identify new areas of taxation, improve compliance and strengthen enforcement.

The latest of the tax reforms committees, namely, the Chelliah Committee, submitted its Interim Report in December 1991 and its Final Report in August 1992. This Committee drew attention to the alarming scale of tax evasion in India and attributed the same to high tax rates, complex procedure of tax compliance, legal complexity leading to prolonged litigation, and, on top of everything, administrative lapses, inefficiency, corruption and nexus between influential tax evaders and political elements.

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3The important study groups include (1) the Taxation Enquiry Committee headed by Professor John Matthai (1953-54), (2) the Paper on Indian Tax System prepared by Professor Nicholas Kaldor at the invitation of the Government of India (1956), (3) the Direct Taxes Administration Committee headed by Professor Tyagi (1958), (4) the Committee on Rationalization and Simplification of the Tax Structure headed by Mr. S. Bhoothalingam (1967), (5) the Direct Taxes Enquiry Committee headed by Mr. N.N. Wanchoo (1971), (6) the Taxation Enquiry Commission headed by Dr. K.N. Raj (1972), (7) the Study on Direct Taxes undertaken by the Economic Administration Reforms Committee headed by Professor L.K. Jha (1983) and (8) the Tax Reforms Committee headed by Professor Raja J. Chelliah (1991).
The setting up of the Chelliah Committee signalled the beginning of the latest round of comprehensive tax reforms. The Chelliah Committee Reports were well received by the Government and many of the recommendations were implemented from the very next financial year, 1992-93. Although recommendations specific to the corporation income-tax were made only in the Final Report of the Chelliah Committee, reform of the other direct taxes and administrative reforms began with the recommendations of the Interim Report itself. The major reform measures implemented by the Government have consisted of (i) reduction of tax rates, (ii) removal of distinction in the tax treatment of widely-held and closely-held companies and (iii) simplification of tax laws and administrative procedures for enhancing administrative effectiveness and efficiency.

Most of the taxation enquiry committees recommended that direct tax laws must be simplified and tax administration must be 'streamlined'. However, they have not, apart from suggesting some administrative steps here and there, defined what exactly is required to be done to 'streamline' administration. The exact relationship between tax reforms and tax administration was also not studied in depth. Few empirical studies were undertaken with reference to actual data collected from the tax paying entities. As a result, most of these recommendations have either not been implemented in the way they ought to have been or have not yielded the desired results: tax laws remain as complicated and tax evasion continues to be as prevalent as (if not more than) ever.

This study makes a modest and humble attempt to fulfill these gaps. It examines the existing schemes of corporate taxation in the country in the context of the theoretical and applied aspects of the tax, analyses the tax behavior of a cross-section of Indian companies in the pre- and the post-reforms periods and evaluates the impact of the latest tax reform programme on the tax behaviour of companies and on tax administration, using empirical data collected from a sample of Indian
companies. The study has used new conceptual tools like the *Deduction-Tax Ratio* for predicting the changes, at a given level of pre-tax profit, in income-tax paid by companies, in response to cuts in deductions allowed. New methods like *ordering of seriousness of problems*, *problem-ranking by using a linear scale* and *ranking of reform measures* through assigning of scores have been tried, for measuring the administrative changes brought about by tax reforms. The scope of this study is limited, however, to the taxation of domestic companies only.

**Objectives of the Study**

Almost all the Tax Enquiry Committees dealt with direct taxes on the whole and not exclusively with the corporation income-tax. Norwithstanding the studies conducted by individual researchers and institutions on different aspects of corporate taxation, gaps do exist in the scope of *empirical* studies that have gone into the issue of corporation tax structure, administration and reforms. In view of these facts, this study was undertaken with the following objectives:

1. **To study the problems in the existing scheme of corporate taxation in the country;**

2. **To examine the inter-relationships between companies’ turnover, profits, capital assets, investments, income-tax paid and the deductions and exemptions availed by them;**

3. **To evaluate the tax reforms programme of the Government of India in terms of improvement in tax administration and enforcement;** and

4. **To suggest suitable policy measures for increasing the collection of corporation income-tax and enhancing the effectiveness and efficiency of corporate tax administration.**

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On the lines of the *Capital-Output Ratio*, which measures the amount of additional capital required to produce each extra unit of output, or conversely, the amount of extra unit of output produced by each unit of added capital. The *Deduction-Tax Ratio* seeks to measure the amount of deductions required to be withdrawn or cut to raise each extra unit of income-tax paid, or conversely, the amount of extra unit of income-tax realized from companies in response to each unit of deductions cut.
The Hypotheses

Most literature on the current scheme of corporation tax in the country acknowledges the fact that the tax laws give a large number of deductions and exemptions to companies, resulting in far too low tax realizations and in the existence of many "zero-tax" companies that pay no tax at all. It is also a common refrain that the income tax laws have become extremely complicated and are full of loopholes, not only making it possible for tax evaders to escape the tax net, but also rendering tax administration ineffective and inefficient. In the light of these common public perceptions about the corporation income tax, this study seeks to test the following hypotheses from analyses of actual data:

(1) *The tax exemptions and deductions offered to companies have constituted a major drain on the resources of the country in terms of foregone tax revenues and have created a large gap between the Statutory and the Effective Tax Rates;*

(2) *The tax reforms initiated in the country since 1992-93 as part of the process of economic liberalization have not improved tax administration significantly.*

Research Methodology

(a) **The Data Base**: This study has used secondary data from sources such as the All-India Income-Tax Statistics published by the Central Board of Direct Taxes, Reports of the Comptroller and Auditor General of India, Annual Reports of the Ministry of Finance, Reports of various Taxation Enquiry or Reforms Committees, Reports on Currency and Finance and Bulletins published by the Reserve Bank of India, Annual Economic Surveys published by the Ministry of Finance, reports and monographs published by the National Institute of Public Finance and Policy and other published articles in various journals and periodicals.
Primary data have been collected through pre-designed and structured questionnaires from a sample of Indian companies located across the country, covering all major areas of industry. The questionnaire contained three parts: the first part, captioned "GENERAL INFORMATION", elicited information on the financial aspects of the companies such as annual turnover, profit before tax and depreciation, capital assets and investments, returned and assessed incomes and income-tax paid. The second part, titled "TAX ADMINISTRATION AND REFORMS", consisted of questions relating to the problems faced by companies in income-tax matters, the rate structure of corporation income-tax, efficiency and effectiveness of the tax administration machinery, responsiveness of tax administration, cost of compliance with income-tax laws/rules, time taken by income-tax proceedings, degree of improvement in tax administration, direction and effects of tax reforms and steps to be taken to improve tax compliance, collections and administration. The third and final part, named "TAX EXEMPTIONS AND DEDUCTIONS", sought data on exemptions and deductions availed by companies under different provisions of the Income-Tax Act. A specimen of the questionnaire used in this study is given in Appendix IV.

(b) The Time Span: The time span of the study consists of six financial years\(^8\) which is divided into two parts. The first part (financial years 1989-90 to 1991-92) represents the period immediately preceding the initiation by Government of the tax reforms programme (and referred to as the "Pre-Reforms" or the "Before Reforms" period). The second part (financial years 1992-93 to 1994-95) represents the period immediately following the initiation of tax reforms (and referred to as the "Post-Reforms" or the "After Reforms" period).

(c) Data Analysis: Data collected from the above sample companies were fed into a Pentium 8MB 100 MHz personal computer and analyzed using dBase III

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\(^8\)The expression "assessment year" has been used at some places in the study to mean the period of twelve months commencing on the first day of April of the said year and corresponds to the financial year immediately preceding that year.
Plus and Microsoft Windows-95 based Visual Foxpro software packages, with the help of computer programmes specially created for the purpose of this study. The data collected have been analysed by using statistical techniques like computation of simple correlation coefficients between variables and step-wise linear multiple regression analysis.

The Sample Profile

For purposes of analysis, the sample companies have been classified in four different ways. They have been divided into (i) three groups on the basis of their average turnover in the post-reforms period, (ii) eight groups on the basis of their area of activity or the sector of industry in which they are engaged, (iii) two groups on the basis of their ownership and (iv) four groups on the basis of the location of their principal places of business. The purpose of classifying sample companies in this way is to identify and quantify possible similarities or variations in tax behavior of companies across different size-groups, sectors of industry, patterns or ownership and regions of location and in the impact that the tax reforms programme has had on such groups.

(a) Classification on the basis of turnover: For determining the size of a company, its turnover in a given year appears to be a reasonable criterion, since the latter measures the volume of business that a company has done during that year. The average turnover of sample companies during the post-reforms period has, therefore, been adopted as the basis for classification. Since the highest average turnover of any sample company in the post-reforms period was Rs. 4519 crore, companies have been classified into three groups within that turnover limit in such a way that there are nearly the same number of groups in each category. The resulting classification is shown in Table-1.1 below:
### Table-1.1: Turnover-based Classification of Sample Companies

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Range of Average Post-Reforms turnover</th>
<th>Company Classification</th>
<th>No. of Companies*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Less than and up to Rs. 23.50 crore</td>
<td>Small Companies</td>
<td>57</td>
</tr>
<tr>
<td>2</td>
<td>Above Rs. 23.50 crore but below Rs. 85.00 crore</td>
<td>Medium-sized Companies</td>
<td>57</td>
</tr>
<tr>
<td>3</td>
<td>More than Rs. 85.00 crore</td>
<td>Large Companies</td>
<td>56</td>
</tr>
<tr>
<td></td>
<td><strong>TOTAL</strong></td>
<td></td>
<td><strong>170</strong></td>
</tr>
</tbody>
</table>

*Figures in parentheses indicate percentage to total.

In classifying the sample companies on the basis of their turnover, one limitation faced by the researcher is that there is no nationally accepted standard classification, nor is a small or a medium-sized or a large company defined anywhere in the Income-Tax Act or the Companies Act. The method of distributing sample companies into three equal groups on the basis of their average post-reforms turnover was adopted as the best available alternative. If companies were to be divided into three groups of equal turnover range, then the limitation would be that most of the sample companies would come within one category and there would be just a few companies in the other two categories. To avoid this kind of skewed distribution of sample companies, the researcher has followed the method described above.

(b) **Regional Distribution of Sample Companies**: The regional distribution of sample companies made on the basis of location of the companies' principal places of business shows that there has been a balanced representation from all the regions of the country, namely, northern, southern, western and eastern India. The distribution pattern is shown in Table-1.2.
Table-1.2 : Regional Distribution of Sample Companies

<table>
<thead>
<tr>
<th>Region</th>
<th>States Represented</th>
<th>Small Companies</th>
<th>Medium-sized Cos.</th>
<th>Large Companies</th>
<th>All Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>NORTH</td>
<td>Delhi, Haryana, Madhya Pradesh, Punjab, Rajasthan</td>
<td>10 (17.5)</td>
<td>15 (26.3)</td>
<td>10 (17.8)</td>
<td>35 (20.6)</td>
</tr>
<tr>
<td>SOUTH</td>
<td>Andhra Pradesh, Karnataka, Kerala, Tamil Nadu</td>
<td>27 (47.4)</td>
<td>16 (28.1)</td>
<td>16 (28.6)</td>
<td>59 (34.7)</td>
</tr>
<tr>
<td>WEST</td>
<td>Goa, Gujarat, Maharashtra</td>
<td>15 (26.3)</td>
<td>16 (28.1)</td>
<td>23 (41.1)</td>
<td>54 (31.8)</td>
</tr>
<tr>
<td>EAST</td>
<td>Assam, Bihar, Orissa, Uttar Pradesh, West Bengal</td>
<td>5 (8.8)</td>
<td>10 (17.5)</td>
<td>7 (12.5)</td>
<td>22 (12.9)</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>57 (100.0)</td>
<td>57 (100.0)</td>
<td>56 (100.0)</td>
<td>170 (100.0)</td>
</tr>
</tbody>
</table>

Figures in parentheses indicate percentage of the total number of companies in each category.

The largest representation of companies is from southern India, followed by western India, northern India and eastern India, in that order. The pattern of representation is almost the same for the small and medium-sized companies as well, but in the case of large companies, the largest representation comes from the western region, followed by the southern, northern and eastern regions.

(c) Classification on the basis of Nature of Ownership of Companies:
Among sample companies, 150 companies are in the private sector, 19 are in the public sector and one is in the joint sector. For purposes of analysis, the public and joint sector companies are grouped together under the head “Public Sector” since there is only one joint sector company in the sample.

(d) Classification on the basis of Sector of Industry: The sectors of industry and the specific areas of activities in which the companies are engaged are shown in Table 1.3.
Table 1.3: Sector-based Classification of Sample Companies

<table>
<thead>
<tr>
<th>Sector No.</th>
<th>Sector of Industry</th>
<th>Areas of Companies’ Activity</th>
<th>No. of Companies*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>MANUFACTURING</td>
<td>Manufacturing various products</td>
<td>40 (23.5)</td>
</tr>
<tr>
<td>2</td>
<td>CHEMICALS</td>
<td>Chemicals, Fertilizers, Petroleum, Petrochemicals, Lubricants, Pharmaceuticals, Paints and Photographics</td>
<td>33 (19.4)</td>
</tr>
<tr>
<td>3</td>
<td>SERVICES</td>
<td>Air Transport, Finance, Hotel, Housing, Publishing, Shipping, Trading and Extension</td>
<td>21 (12.3)</td>
</tr>
<tr>
<td>4</td>
<td>TEXTILES</td>
<td>Textiles and Textile Yarns</td>
<td>18 (10.6)</td>
</tr>
<tr>
<td>5</td>
<td>ELECTRONICS &amp; ELECTRICALS</td>
<td>Computer Software, Electronics and Electricals</td>
<td>14 (8.2)</td>
</tr>
<tr>
<td>6</td>
<td>ENGINEERING</td>
<td>Engineering, Explosives, Mining, Ship Building and Quality Testing</td>
<td>11 (6.5)</td>
</tr>
<tr>
<td>7</td>
<td>OTHERS</td>
<td>Cables, Confectionery, Stationery, Leather, Paper, Plastics, Glass, Steel and Contraceptives</td>
<td>16 (9.4)</td>
</tr>
<tr>
<td>8</td>
<td>CONSTRUCTION, AGRO-INDUSTRIES AND AUTOMOBILES</td>
<td>Real Estate and Cement, Tea, Tobacco, Sugar, Silk and Food Processing, Automobiles, Auto accessories and Tyres</td>
<td>17 (10.0)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>T O T A L</td>
<td>170 (100.0)</td>
</tr>
</tbody>
</table>

*Figures in parentheses indicate percentages to total.
Chapter Scheme of the Study

The study is divided into five Chapters the contents of which are outlined below:

Chapter I: Introduction and Research Plan

This Chapter highlights the significance of the study, enumerates its objectives and hypotheses, explains the research methodology, the sample profile, the Chapter scheme and limitations of the study and identifies potential areas for further research.

Chapter II: Corporate Taxation : Theory & Practice

This Chapter examines the theoretical and applied aspects of corporation income tax including the case for separate taxation of corporate incomes, the incidence and impact of corporation income-tax, various systems of corporate income taxation, problems in the existing scheme of corporate taxation in India, corporate tax reform, relationship between tax administration and tax reform, issues in corporate tax administration, corporate tax reforms in India and international trends in corporate tax reforms.

Chapter III: Tax Behavior of Indian Companies

This Chapter presents a detailed analysis of the tax behaviour of the sample companies with reference to data obtained from them and examines the relationship between income-tax paid by companies on the one hand and average turnovers, profits, returned income, income-tax paid and deductions availed, on the other. Statistical techniques like simple correlation and stepwise linear multiple regression analysis have been used. For ascertaining the impact of the tax reforms on companies’ tax behaviour, comparisons are made between tax behaviour of
companies in the pre- and the post-reforms periods, across size-groups, sectors of industry, ownership-groups and regions.

Chapter IV: Evaluation of the Indian Tax Reform Programme

This Chapter analyses the views and experience of Indian companies in complying with the corporate tax laws in the two periods and evaluates the on-going tax reforms programme in terms of the nature and extent of administrative improvements brought about by reforms.

Chapter V: Summary Conclusions and Suggestions

This Chapter summarizes the results and findings of the study and presents appropriate policy suggestions for enhancing tax compliance and revenue collections, checking tax evasion and making tax administration more efficient and effective.

Limitations of the Study

The researcher is aware that, given the existing number of corporate taxpayers in the country, the sample studied is quite small, but to the best of his knowledge, few other studies have gone deeper into the structural and administrative aspects of corporate taxation on the basis of empirical data. To obtain more representative and realistic results, the researcher had proposed to collect data from a larger sample and mailed questionnaires to over 9000 companies listed on the National Stock Exchange of India. In an attempt to make the study as broad-based as possible, the researcher also travelled personally to many major cities in the country and appealed to tax professionals, chambers of commerce and other business groups and consortia to complete the questionnaires. However, in spite of personal contacts and repeated postal reminders, only about 250 companies
the questionnaires duly filled in, of which only 170 were found to be complete in all respects.

During the process of data collection, it was noticed that there is widespread misapprehension and utmost reluctance on the part of companies to part with any information relating to their income-tax matters. However, the researcher is glad that sustained persuasion and devoted efforts resulted in as many as 170 well-known and reputed companies furnishing valuable data. The study, therefore, does not claim to be an all-exhaustive treatise on the subject. The researcher has done his best to collect as much data as possible, without compromising on reasonable accuracy and correctness of information obtained.

Secondary data available on the subject are not free from time-lags and other errors. The limitations of secondary data have been well documented and acknowledged by many other researchers working in this area.

The time period of three years selected for assessing the impact of the tax reforms programme could be regarded by some as too short; but, in an age of rapid economic and technological change, it might not be desirable to wait for more time to elapse, since the data collected or the objectives of the study might become less relevant from the point of view of tax policy. There must, therefore, be a sense of urgency in implementing the suggestions emanating from this study, as well.

Potential Areas for Further Research

Further disaggregated analyses of tax behavior of companies could be attempted with other bases of classification such as profit before tax, types of deductions availed, products manufactured/marketeted/dealt with, etc., and with larger samples or a longer time-frame. Relationship between the level of corporate

income taxation and those of corporate savings and investments could be investigated. The tax reforms programme could be evaluated with reference to the problem-areas not included in this study. Specific issues like presumptive taxation of companies and alternative systems of corporate taxation involving a change of the tax base (other than profits) might also be useful topics for research.

Disclaimer

The views expressed by the researcher in this study are only in his personal capacity as a student of economics and are not in exercise of his official capacity as an Assistant Commissioner of Income-Tax in the Indian Revenue Service. They do not purport to represent the official views of the country's tax administration or of the Income-Tax Department.