CHAPTER I

INTRODUCTION

Taxation is a vital instrument in the fiscal armoury of the government. By taxing the well-to-do classes of society according to their capacity\(^1\), the government collects the revenue and then spends on services which are beneficial to the community as a whole. Taxing people, is not a new phenomenon developed by the modern governments. It is interesting to notice that even primitive and ancient societies could boast taxation in order to discharge their public obligations and meet the needs of security\(^2\). The profit of a merchant or the livestock of an agriculturist were subjected to some sort of taxation in the ancient days. During the Vedic times, the principle of taxation or the method of meeting expenditure by resorting to taxation was a recognised necessity and an important government function in whatever form it might have been enforced\(^3\).

The primary objective of levying taxes is to raise revenue by transferring resources from the public to the government\(^4\). However, this objective may be sufficient only in the case of developed countries. The aim of the tax policy in a developing country should also be to remove the inequalities of incomes in the society. This principle of equity assumes more importance in India, where the urge for equality of income is very great\(^5\). The tax policy should impart built-in flexibility into the tax structure and
provide continuing maximum revenue productivity consistent with the optimum growth rate. The built-in flexibility woven into the tax structure brings in the additional revenue to the state as income rises without frequently going for legislative sanction and at the same time provides for an anti-inflationary mechanism. The built-in flexibility of a particular tax depends on the width of the tax base relative to national income, the responsiveness of the tax base to change in national income, and the rate structure of the tax. So the tax policy should aim at maximum possible built-in flexibility in the tax structure, specially in developing countries where the need for the extra resources is very urgent.

The tax structure of developing countries should be so designed that it is not only instrumental in mobilising savings but also it does not adversely affect the inducement to invest. Moreover, tax policy, besides aiming at economics growth, should play a positive role in bringing about economic stability, allocative efficiency, and optimum income distribution in underdeveloped countries. It should be remembered that although the basic aim of tax policy is to raise revenue with rising income and to increase public savings for productive capital formation, it should try to achieve some desired economic and social objectives. The modern theory and system of taxation in India are largely based on the British practice. However, after the independence, there was a radical change in the government
attitude towards the tax structure and policy. Under the British rule, the aim of tax policy was only to raise funds for running the government, now the objective is not only to collect revenue but also such collection is to conform to certain socio-economic policies aimed at achieving maximum social good.

Suggesting a tax system for India, Prof. Kaldor says " a sound tax system should have three pillars: equity, economic effects and administrative efficiency".8

According to him the tax system should not contain a bias in favour of a particular group of taxpayers. This is not to say that progressive rate of taxation is inapplicable. The second consideration is that the tax system must have proper economic effects and should not weaken the incentive to work, save, and take risks. The third requirement is that the tax system must be comprehensive and simple and must make for efficiency of the administration and prevent large scale tax evasion.

The Taxation Enquiry Commission precised the aim of Indian tax policy in these words, "On the whole, the kind of tax system which would be best adopted to meet the requirements of the Indian economy, having regard to the development programme and
the resources for investment available to the public sector with as small as diminution as practicable of investment in the private sector, and which, therefore, is accompanied by the largest practicable restraint on consumption by all classes".  

Mitigation of economic inequalities is the second primary objective of our tax policy, which is also a directive principle of our constitution. Chelliah described that "Inequalities of income and the concentration of wealth in the hands of a few may carry with the concentration of economic power; and when large wealth-holding are transmitted through inheritances and bequests, a class of rentiers is created, who can earn large income and consume it without any social justification to support their claims on the social product. Thus there are three undesirable consequences of inequalities: disparities in the standard of consumption, concentration of economic power, and the creation of a class of rentiers. The problem then really is to prevent or mitigate these consequence without inhabiting growth."

The above inequalities of wealth and income can only be tackled by a well-co-ordinated tax system.

Although taxation may have a large role in promoting a country's development, its actual efficiency will depend on the choice of various possible types and kinds of taxes.
While making this choice the government of different countries, as Meier and Baldwin State,

"have to consider such matters as their particular legal systems, the balance of political and social power within the country, the administrative ability to enforce the tax comprehensively and justly, the effects of different taxes on incentives, and the objective of a proper balance between short-term revenue raising measures for financing urgent development projects and long term reforms which will give steady encouragement to economic development over the longer pull".12

Taxes have been broadly categorised into direct taxes and indirect taxes. We are concerned here with direct taxes only, which involves a direct money burden. In the case of direct taxes, there is a direct effect on the taxpayer by way of a burden and equitable distribution of tax burden poses real problem. The objective of any tax system should be to minimise the total direct real burden. All people in the same economic position should be equally taxed. Almost all the developed and developing countries of the world today place much reliance on direct taxes as a means of generating saving and capital formation.

INCOME TAX - HISTORICAL BACKGROUND

In its modern form, the Income-Tax was first introduced in India in 1860 by John Wilson, to tide over the financial
stringency caused by the mutiny of 1857, which was abolished in 1865. During the period 1860 to 1886, as many as 23 Acts were passed in the field of direct taxation. Finally, the first systematic Act of income-tax was enacted in 1886. Since then income-tax became a permanent feature of the Indian Tax System.

The legislation of 1886 is a milestone in the history of income-tax in India. It was not only the end of experiments period in taxation but also it provided a base to the structure of the subsequent Income-Tax Acts including the Income-tax Act 1961. The legislation of 1886 excluded agricultural income from the ambit of the income-tax, because agricultural income was subjected to a corresponding burden in the shape of a cess. Under the Income-Tax Act 1886, all incomes were classified under four heads:

1. Salaries and pensions
2. Profit of companies
3. Interest on Securities and
4. Income from other sources.

It was a scheduler tax as each type of income was taxed separately without reference to the others. The Income Tax Act 1886 continued, with minor changes, till 1918 when this was replaced by the Income Tax Act 1918. The new Act introduced major changes in the taxation of Income. The scheduler system was abolished and the income tax was made
global tax in the sense that the tax liability was based on the total income of the assessee.

Consequent upon the inclusion of income tax under the central revenue list through the government of India act, 1919, it had become necessary to introduce a new Income Tax Act. From 1st April 1922, the Income Tax Act 1922 came into force. On the recommendation of Income Tax Enquiry Committee, some important changes were introduced in the Income-Tax System, in 1939. The step system of Income-Tax rates was abolished and slab system was introduced. The Income Tax Act 1922, as amended from time to time continued till 1961. In 1961, a new Income Tax Act was introduced.

A BRIEF REVIEW OF INDIAN INCOME TAX STRUCTURE

Over the past few decades, there has grown in India a fairly elaborate and complicated structure of Income Tax. As it stands now, this tax structure is marked by the absence of any formal coherence, and is also somewhat inconsistent with the principles underlying for income taxation. The structure is, in fact, no structure at all, and could be described rather as a shapeless product, the result of recurrent financial need and promiscuous piecemeal legislation. In its present configuration, it is no more than an accidental grouping of laws enacted at different times for different purposes. Actually there has been no long-term policy behind our taxation law. Income-tax structure in India is completely based on trial and error
system. It is characterised by lack of stability. In fact, the Indian Income Tax law is like a railway ticket, which is valid for only one year journey and sometimes not even for a full year. The government alters the tax structure every year by the Finance Act. Income-tax structure in India is very complicated. Nothing to say of a layman, even the Income tax experts and tax assessing officers are finding themselves unable to be conversant with the interpretations of some provisions and the latest amendments. This fact has been admitted by the government and the Finance Minister has stressed the government commitment to simplify the tax structure in order to make it more scientific and free from interpretational hazards. This tax structure contains a number of superfluous provisions, which have no use and exist merely to complicate the tax structure.

It seems that Income tax has become a controlling steering of Indian economy. The government wants to achieve all the economic goal through income tax. Any effort for simultaneous realization of all set national objectives through income tax, would prove to be a futile and less meaningful exercise.

The present way of operating the income tax is clearly unjust. It taxes far more than proportionately the incomes of the salaried persons and those who choose to remain honest. Others with high incomes from business and professions, are getting away without paying full share of their tax liability. The honest taxpayers, particularly the
salaried class, is demoralised.

MAJOR OBJECTIVES OF THE STUDY

In the light of foregoing discussion, the present work focuses:

i) to examine the importance and composition of income-tax revenue in India;

ii) to suggest suitable modifications in the irrational provisions, to make the tax structure simple and rational;

iii) to examine, the level of income-tax exemption limit, and the rate structure;

iv) to examine the effects of inflation on the tax burden of individual assessees; and

v) to evaluate the performance of income-tax administration.

In telegraphic language, the study is intended to pinpoint the defects in income-tax structure and to suggest suitable reforms.

RESEARCH METHODOLOGY

The core of the study is based on secondary data obtained from different government publications and from the earlier
studies in this field. Informations about the Indian tax system are extracted from the taxation laws published by the government and informations about foreign countries are taken from different publications and also collected from the embassies of different countries. A few parts of the study also utilise primary data based on verbal interviews of the taxpayers and tax professionals. As the data and the informations are obtained from authenticated publications, the probability of errors is almost nil.

PERIOD OF STUDY

To achieve the underlying objectives of the study, it was considered necessary not to tie up the work in a specific period of time and hence the time period varies from chapter to chapter and sometimes even within a chapter.

LIMITATIONS OF THE STUDY

Income-Tax is a very vast subject and it was not possible to cover the whole income-tax law in the present work. So the study is limited to certain points which assume crucial importance nowadays.

PLAN OF THE STUDY

The work is divided into seven chapters.

Chapter I: introduces the subject, explains the objectives of the study and gives descriptions of the various chapters.
of the study.

**Chapter II** : examines the level of taxation, real growth in tax revenue, relative importance of direct and indirect taxes and the composition of income tax revenue.

**Chapter III** : makes an attempt to identify the superfluous, out dated, illogical and unjust provisions in the income tax law and suggests suitable modifications in order to make the tax structure simple, rational and justifiable.

**Chapter IV** : addresses the questions relating to the exemption limit and the rate structure of personal income-tax in India.

**Chapter V** : examines the effect of inflation on the tax liabilities of individuals at different inflation rates, analyses the various possible inflation adjustment schemes, makes reference of foreign countries on this aspects and suggests the measures to neutralize the impact of inflation in the income-tax system.

**Chapter VI** : evaluates the performance of income tax administration and

**Chapter VII** : gives the summary and conclusion of the study.

Instead of going into the deep theoretical aspects of taxation, the study emphasises only on the practical aspects
of the income taxation. However, some theoretical concepts were also discussed wherever it was deemed extremely necessary. Efforts are also made to present the work in a very precise manner.
NOTES AND REFERENCES

1. Stamp S.J. : Wealth and Taxable capacity, P-134
10. The constitution of India Part IV Article 38(2) inserted by 44th Amendment in 1978.
11. Chelliah R.J. Fiscal policy in underdeveloped countries with special reference to India P.22
12. Meier and Baldwin Economic Development - Theory, History and policy, Asia publishing House, 1957 P.393