Chapter XI

CONCLUSIONS AND SUGGESTIONS
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The study of Indian Income-tax attempted in the preceding chapters is focussed mainly on the coverage of the base and the sources of its erosion. Starting from the premise that if the claim to superiority of income tax is to be justified the base must be comprehensive enough to include all elements of the power to command goods and services, we have endeavoured to show that the grounds on which the coverage of the base is usually curtailed in practice, viz., considerations of operational difficulty and priorities of public policy, are not always valid. It is possible to enlarge the base significantly even within the constraints of administrative limitations and the compulsions of social and economic policies. We thought that widening of the income tax base was important not only for equity but in the interests of effective administration of the tax since a wider base would help to bring down the high marginal rates which are believed to be largely responsible for the phenomenon of evasion. We assumed that earnest efforts to improve the yield and the potential of the income tax were called for in order to arrest the drift towards heavy indirect taxation noticeable in recent years as it is extremely difficult to build up an equitable tax structure

by relying wholly on commodity taxes. Study of the income tax from the angle of base erosion was needed also to improve the efficacy of tax incentives as an instrument of policy.

It has been suggested that a major factor in the narrowing of the income tax base as compared to a comprehensive definition of income, like the net accretion concept, arises from the problem of valuation. To avoid this problem, for purposes of taxation, income was recognized only on realization. Application of this rule however created several problems. First, the criterion of realization proved difficult to define with any degree of precision with the result that its actual working was often marked by inconsistencies (e.g., in the rule of stock valuation). Secondly, it gave rise to the bunching of several years' gains in one year's receipts which it was inequitable to tax like regularly accruing income under a progressive system. Attempts were made to resolve these problems in various ways. One approach - rooted in the British tradition and followed in India for a long time - was to treat all irregular gains as 'capital' and leave them out of the tax base. Total exclusion of all capital gains however caused uneasiness as it conflicted with the principle of ability to pay. The problem was met halfway by subjecting realized capital gains to tax but relatively leniently. Any preferential treatment of capital gains however required defining such gains to distinguish them from income. These problems have thwarted a rational treatment of capital gains in Indian income tax too.
The tradition of treating infrequently occurring gains as 'capital' has resulted in the exclusion from the tax base of gains from certain sources even when realized (e.g. gains on transfer of goodwill of business). Treatment of unrealized capital gains still awaits a satisfactory solution.

Valuation difficulty has also inhibited the inclusion of imputed incomes (notably from home-owning) in the income tax base, with adverse effects on the equity as well as the neutrality of the tax. To compensate for the discrimination against non-property-owning tax payers involved in such exclusion, suitable deductions are often suggested in the computation of taxable income (e.g. deduction for house rent paid by taxpayers living in hired houses to ensure parity of treatment between home-owners and rent-payers). Liberal allowances for cost of earning in the determination of business income as against those for income from employment lend support to the plea for retaining the special provisions in the tax laws since removal of all exemptions and concessions might not be fair to all sections of taxpayers.

We have argued that the principle of compensatory relief (even though sanctioned by the second-best theorem in welfare economics) is self-defeating for progressive taxation. Since perfect parity among all sections of taxpayers is unattainable,

if carried to its logical end, this principle would grievously impair the vertical equity of the tax and frustrate the redistributive function of progressive taxation. Therefore, the aim should be to adhere to the comprehensive concept as closely as possible. We have shown that even allowing for the problems involved in measuring income the income tax base can be made more comprehensive than it is at present.

Exemptions and deductions allowed from the tax base to promote various objectives of social and economic policy and these constitute the other major source of base erosion stand on a separate footing. If however inroads made into the base on these grounds are to be justified, there must be a demonstrable social gain from each of them adequate to outweigh the cost in terms of equity and revenue. Our examination of some of the provisions in the Indian income tax intended to promote social and economic objectives showed that not all of them would pass this test. Some have outlived their utility and some require to be redesigned to sharpen their incentive edge while in the case of quite a few the rationale is either obscure or weak. In other words, many of them might be scrapped without any detriment to the policy objectives. The main suggestions emerging from the study are briefly set out below:

1. All realized gains, whatever the source or form, should be brought into the income tax base. Capital gains, casual gains, and benefits-in-kind should all be included in taxable income. Constructive realization should be imputed
at the time of gifts and bequests. The problem of bunching resulting from the application of the realization rule can be taken care of through averaging or proratring. Prorationing will be administratively simpler.

If the above scheme appears to be too radical, the existing system of taxing capital gain should be tightened up to ensure that gains like those on transfer of goodwill or liquidation of companies do not escape taxation. The definition of 'capital asset' in the Income-tax Act should be suitably expanded. Capital gains from agricultural land should be subjected to taxation under the Central income tax.

2. The area of accrued gain excluded from the base because of operation of the realization principle should be reduced to the minimum. For this purpose, the stock valuation rule (lower of market-value or cost) should be revised to ensure that only net realizable value is taken into account while valuing closing stock. Imputed incomes from all consumer durables above a certain value and from service rendered to one's own household in so far as it involves exercise of one's professional skill should be included in the base subject to certain exemption for administrative reasons. Capitalisation of company profits through the issue of bonus shares should be recognized as distribution and profits so capitalised taxed in the hands of shareholders. Alternatively, capital gain on transfer of shares should be computed by spreading of the invest-
ment cost over both original and bonus shares.

In-kind benefits should be valued at their market price and included in income.

3. To prevent base erosion through deduction of consumption expenditures in the garb of earnings cost facilitated by the increasingly liberal application of the business expense deduction rule, it is necessary to introduce limits on all indirect costs incurred in business (that is, other than cost of material, wages and salaries and a few other items like power and rent). Business expense deduction rule also should be modified by introducing an additional qualification that it must be incurred necessarily for earning the profit or income in question. Expenses relatable to tax exempt income and those which go clearly against public policy should not be allowed to be deducted whether they appear as expenditure or as loss. Differentiating 'losses' from 'expenditure' for such purposes makes no sense.

4. Long-term expenditures of limited life (apart from those embodied in depreciable assets) should be amortized. Broad categories of such assets should be identified and the period of amortization laid down. There is no case for amortizing goodwill. There should be a provision to recapture amortized expenditures on transfer of business. (This however would not be called for if all goodwill gains were subjected to tax like ordinary income). Abortive expenditures should not be amortized
unless they lead to setting up of a business.

It is illogical to look upon depreciation as a cost item since true economic depreciation cannot be determined in a world of changing prices, technology and uncertainty. Despite the rise in prices depreciation allowed in recent years has been more than adequate for purposes of replacement.

A simple way of rationalising depreciation allowances is to follow the straight line method and adopt two basic rates, one for productive plant and machinery other than office appliances, and another for assets of other varieties. The rate for the former may be fixed at 20 per cent and the latter, at 10 per cent of the cost. Asset account may be kept under these two broad heads and all proceeds of assets sold, credited to this account, and depreciation actually allowed, debited to it. The balancing allowances/or charges may be applied only on the winding up of the business.

Deduction for current repairs should be restricted to 5 per cent of the original cost or a specified fraction of the depreciation.

Considering the need to promote employment, there is no justification for providing any capital allowance at present apart from depreciation as above. Rather, some subsidy for employment may be considered.

Incentive for research and development should be given in the form of a straight subsidy rather than through a tax concession.
5. Deduction for losses should be treated as essentially an averaging device. Hence loss offset may be allowed only in respect of a trading loss against income from any other source or head of the same year. But carry-forward and offset of past losses and also of unabsorbed capital allowances should be permitted only against income from the same source. Losses should be allowed to be carried back for three years. There is no case for permitting any deduction for loss under any other head. Where capital gains are subjected to tax, capital losses also should be allowed to be offset but only against capital gain of the same category (that is, long-term loss against long-term gain, etc.) In the present system of taxation there is no place for deduction of losses in respect of personal assets (i.e., consumer durables) from income.

6. Exemptions and deductions provided by way of incentive for promoting growth or other economic and social objectives should all be examined from the cost-benefit angle. The incentive for saving through specified media should be related to the net increase in investment in those media. Adequate measures should be taken to tax the return of tax-exempt contributions to provident and other funds in order that these incentives do not serve as avoidance device. To mitigate the regressive effect of the incentives, relief should be provided in the form of a tax credit at a flat rate on the saving rather than in the form of a straight deduction. Incentive for charity also should be given, if at all, in the form of a tax credit.
and that too only for contributions to institutions like universi-

ties.

The incentives provided for growth of industries, exports and spread of technical know-how seem to be ill-suited to serve the underlying objectives. They seem to have helped those who are not in need of help. They have also tended to open up avoidance opportunities. Their cost to the community remains unknown. In the case of tax holiday provisions ambiguity of aims has led to conflicting interpretation of the implementing sections of the statute. A close look is required at these provisions in the light of their actual working. In no case should an incentive provision be given retrospective effect.

The newly introduced deduction for house rent paid by non-property owning taxpayers which is likely to cost Rs.30 crores annually is based on questionable logic. The standard deduction for salaried employees is an improvement on the earlier conveyance and book allowance. But it seems to be a little too generous.

Deductions which benefit only a small section of the taxpayers like the one allowed in respect of earning of teachers on short assignments abroad upset taxpayer morale and should be avoided. Deduction from income from book publishing is difficult to administer and should be withdrawn. Some of the equity type deductions (e.g. for expenses on treatment of medically
handicapped child) seem justified, but these reliefs are better provided in the form of straight subsidy. There is little justification for providing any deduction for expenditure on children's education.

Exemption of agricultural income from the tax base affects the equity of the tax in several ways and also provides scope for evasion. But income tax is not a suitable instrument for taxation of farm incomes. The partial integration scheme now in operation takes care of the equity and evasion aspects to a great extent. Exemption of rent from land and income from processing of their produce by farmers (and rent receivers) however seems unwarranted under the present conditions. Preferential treatment of income from dairy and livestock also seems indefensible whether on equity or on economic grounds.

7. Family consisting of husband, wife and minor children should be the basic tax unit. When both the spouses happen to earn, a deduction of 10 per cent of the wife's income may be allowed subject to a minimum of Rs.1000 and a maximum of Rs.2000. To take care of differences in taxable capacity of families with equal incomes but varying sizes, there should be some differentiation in the rates of tax on married couples and bachelors. The differential in the tax burden between single and married persons should narrow down in the upper ranges of income and vanish beyond a certain level.
Heads of households having dependants (like windowers with dependent children) should be allowed to follow the rate schedule meant for married couples. Dependants' income should be included in that of the family unit to which they belong. The Hindu Undivided Family should be derecognized as a tax entity.

8. Surplus of intermediaries should be taxed to their owners or beneficiaries. Taxation of companies should be based on expenditure (excluding wages) rather than profits. If however the tax on corporate profits cannot be replaced, there should be some arrangement for partial integration of corporate with personal taxation. If retention of profits is to be discouraged there should be a tax on undistributed profit at the maximum marginal rate of tax on personal income. Capital gain on equity holdings should be assessed on the basis of break-up value of the shares in the case of persons belonging to the controlling group. Market quotations may be followed, where available, only in the case of shareholders having no connection with the controlling group.

Profits of partnership firms should as far as possible, be assessed in the hands of partners. Where identity of the real partners cannot be established, the firm's gains should be taxed at the maximum marginal rate prescribed for personal income. Dividend or other distribution of co-operatives should be taxed fully in the hands of members. Undistributed surpluses of co-operatives should be subjected to tax. Allocation of shares etc. to members should be treated as distribution.
Losses of consumer co-operatives should be set off only against the profits of the same activities as in the case of any other mutual organization.

Income of trusts for which the beneficiaries are unknown or indeterminate should be taxed at the maximum rate prescribed for personal taxation. Income of private religious endowments should be taxed in the hands of the Shebaits and managers. Non-exempt incomes of charitable trusts also should be taxed at the maximum rate. The recent move to tax anonymous donations of charitable trusts however seems a little too drastic.

Need for a long-term perspective

Most of the suggestions put forward above indicate the lines along which reform can be carried out to improve the yield and efficacy of the income tax within the existing framework. Such reform, it was felt, was needed to remove the irrationalities and anomalies which have crept into the law over the years as a result of ad hoc responses to the problems thrown up in the course of day to day administration and the exigencies of public policy. The aim was to halt needless erosion of the base and widen it as much as possible so as to satisfy the twofold objective of larger revenue and greater equity.

3 The proposal has since been dropped, vide the Taxation Laws (Amendment) Bill 1973 as reported by the Select Committee, clause 5 and finally passed as the Taxation Laws (Amendment) Act, 1975.
It has to be recognized however that there are obvious limits to the widening of the income tax base, especially in a developing country. Apart from the fact that a large part of income in these countries accrues in ways that are not identifiable by the tax authorities being outside the commercial network (e.g., interest on loan to peasants, etc.), there are some fundamental problems in the implementation of a truly comprehensive base, for which there is no completely satisfactory solution. The net accretion definition of income, it is conceded even by its proponents, is not an operational concept. One has, therefore, to be content with "realized" income with all its limitations as the base for income taxation. Moreover, in a developing country objectives like growth are likely to get precedence over others like equity even though it is becoming increasingly clear that growth can have no meaning without some effort towards lessening of inequalities and that the two aims do not necessarily conflict. Fate of even cogently argued reform proposals such as those put forward by the Carter Commission in Canada shows how difficult it is to get even a modified version of the comprehensive base accepted by policy makers. Lack of requisite environment for

4 For much of the prevailing inequality is 'non-functional'. (See for a discussion of this concept, D. T. Lakdawala, Taxation and the Plan (1956).)

enforcing income tax effectively in the less developed countries adds to this pessimism.

If, however, tax reform is to be meaningful, it must be oriented to a long-term perspective. While piecemeal changes are needed to improve the performance of the existing system - and many of the suggestions made in this study are intended to achieve this aim - there should be a sense of direction in which to move as otherwise the short-term measures, however carefully formulated, tend to lose coherence and work at cross purposes. Viewed in this context, and considering the formidable difficulties - theoretical and practical - in reforming the income tax beyond a point, one wonders if it would not be advisable to look for an alternative base which would be more acceptable and serve the policy objectives better. Impediments to a radical reform of the income tax have spurred the search for other bases as a supplement to income tax even in USA in recent years.

The alternatives to income one can think of for purposes of direct taxation are, wealth and expenditure. From several angles the net wealth tax seems to be superior to income tax. It is less injurious to the incentive to earn and take

6 See, for instance, the papers presented at the symposium on "Financing the Seventies" sponsored by the National Tax Association of USA in April 1972 and published in the NTJ, Sept. 1972 and Broad Based Taxes: New Options and Sources (1972), edited by Musgrave.

7 For a discussion of the merits of the net wealth tax, (footnote contd.)
risks, compels efficient use of capital and provides a way of reaching unrealized capital gains; it also provides a check against 'being' rich while income tax can at best prevent one from becoming rich. Difficulties encountered in the identification and valuation of assets however rule out the use of net worth as the principal base for direct taxation. Problems of valuing human wealth and the premium on consumption inherent in wealth tax also detract from its merits. For all these reasons, in looking for an alternative to income as the tax base one has to turn to consumption or expenditure.

The merits of an expenditure tax are well known and need not be recounted here. It might be useful, however, to take note of its main drawbacks. One view is that progressive tax on personal expenditures would be iniquitous because it

(Previous footnote contd.)


9 Problems of administering the tax on net wealth are discussed in detail in "The Taxation of Net Wealth" by M. Tanabe in IMF Staff Papers, March 1967.

tends to tax the young and the old more than the middle aged who usually have a greater capacity to pay. A tax on expenditure, it is also apprehended, will lead to an accentuation of inequalities. Doubts are expressed by some even about its consumption restraining effect. Even so, expenditure tax merits attention because, on the whole, substitution of an equal yield expenditure tax for a tax on income is likely to have a more favourable impact on savings. As for the discrimination against certain age groups, the inequity can be mitigated through an averaging device or other similar arrangements. Besides, in a way, a tax on expenditure might be more equitable than the income tax since consumption expenditures tend to be more evenly distributed over one's lifetime than income. The problem of accentuation of inequalities can be tackled with the help of supplementary levies like the net wealth tax or through more direct measures like nationalization.

It cannot be overlooked however that despite its theoretical merits, the expenditure tax has not gained acceptance

11 This was one of the reasons for which the Carter Commission considered it inferior to income tax (Report of the Royal Commission on Taxation (1966), vol. 3, p. 26).

12 This is based on the argument that savers make their decisions after allowing for tax payments whether it is income tax or tax on consumption. (R. B. Goode, "Taxation of Saving and Consumption in Underdeveloped Countries", NLI, 1961).

in any country so far. In USA a Treasury proposal to introduce a tax on expenditure in 1942 proved abortive. The two countries which experimented with this tax in recent years (India and Ceylon) abandoned it within a short time. The weight of authority against the tax also seems overwhelming. Marshall, Pigou and Keynes - all had expressed doubts about the feasibility of an expenditure tax because of administrative difficulties. To guard against avoidance by showing saving in one year and secretly drawing down assets in another, it will be necessary, under an expenditure tax, to obtain information regarding income and capital transactions, in other words, a balance sheet, in the case of every taxpayer, - a proposition, at the implications which, to quote Prest, "one's mind boggles".

Keeping track of disposal of assets like cash and jewellery is not an easy task even in advanced countries. Treatment of losses and necessitous expenditures occasioned by births, marriages, illness, accident, etc. would give rise to problems under an expenditure tax which do not admit of a simple solution. The possibility of personal expenses being shown increasingly as 'business' also has to be reckoned with.

It would be unrealistic to belittle these problems.

14 For a discussion of the grounds on which the expenditure tax is considered impracticable, see R. E. Slitor, "Administrative Aspects of Expenditure Taxation", in Broad Based Taxes (1973), op. cit.

At the same time it might be pointed out that with a tax based on expenditure and *ipsa facto* exclusion of savings from the base there would be a strong inducement for disclosure of unaccounted wealth which is posing such a problem for administration of the income tax at present. Some are also inclined to think that the problems of administering an expenditure tax may not be any more difficult than those of the income tax. It is also contended that under the income tax as it operates in practice substantial deductions are allowed for saving if invested in certain specified forms - exclusion of unrealized gains itself constitutes an automatic deduction for saving - and a more even-handed deferral of tax on saving would be fairer. The problems of policing can be kept within manageable limits if saving in only specified forms are recognized for tax purposes (so that holding of assets like cash is excluded from saving unless deposited in, say, a bank). Simultaneous operation of a net wealth tax would act as a check against the tendency to overstate savings. Possibility of a larger recourse to expense account living can be countered by imposing a tax on business expenditures.

16 See "Is an Expenditure Tax Feasible?" by Patrick Kelly in NTJ, September 1970.


18 As suggested for companies by Gulati and Bagchi (I. S. Gulati and A. Bagchi, "A proposal for Reforming the Corporation Tax", EPW, Annual Number 1975).
Similarly the risk to revenue from a tax base which will be narrow relatively to income can be minimised if all ingredients of consumption are included in taxable expenditure. The poor yield of the expenditure tax in India during the two periods for which it was in force need not be taken as a conclusive evidence of the revenue potential of the expenditure tax.

It would be rash to suggest however that income should be replaced by expenditure as the base without a careful consideration of the consequences. There would be many problems of administration which cannot be foreseen beforehand. Obtaining full particulars of each taxpayer's assets as at an initial date might be one such problem. It is outside the scope of this study even to anticipate such problems or go into them. All that is contended is that if an alternative to income as the tax base is to be considered expenditure is the only choice.

In any case, if it is considered impracticable to levy the income tax on a comprehensive base, it is necessary to think

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19 The reasons for the low yield are well known. The coverage was so poor that between 1959-1962 on the average only 740 individuals and HUFs (out of a total of over 8 lakhs income tax payers of these categories) came within its purview; in 1964-66 the average was 483. Exemptions and basic allowances were provided so liberally that, in the first period, of the total consumption expenditure of assesses coming within its purview only 25 per cent actually suffered the tax. In 1964-66 this proportion improved to 38.7 per cent but the rates were too low and the assessees were too few to make much difference to the yield. [O. P. Chawla, *Personal Taxation in India* (1972), Chapter VII].
of an alternative which might answer to the needs of growth better and help to reduce the disparities at least in the living standards if not in the distribution of income and wealth. Despite its drawbacks, a progressive tax on expenditure as contemplated by Kaldor supplemented with a tax on business expenditures and a net wealth tax seems to offer such an alternative. This is not to suggest that no attempt need be made to reform the income tax to the extent possible but only to stress that tax reform proposals have to be evaluated on two different planes. They may be seen first as a way of improving the efficacy of the system within the existing framework by attending to the deficiencies noticed in its day to day working. They need to be viewed also in a perspective taking into account the long-term goals of policy and a realistic appreciation of what can be achieved within a given socio-economic milieu.

Although most of the proposals put forward in this study are formulated in the context of the income tax, these on would be of relevance even if it was decided to move/to a base close to expenditure rather than income. For in the determination of aggregate expenditure one has to start from income taken in the comprehensive sense and then allow for savings. A wider coverage of income for purposes of taxation is thus imperative whether the tax is levied ultimately on income or income minus

savings. Many of the problems of base erosion however assume a different character depending on whether the community wants personal taxation to be based on income or consumption. This in turn emphasizes the need for a long-term perspective even if the task is narrowed to reforming the existing tax system in a meaningful way.