CHAPTER 1
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INDIAN TAXATION SYSTEM – AN OVERVIEW

1.1 INTRODUCTION

Tax and taxation is as old as human history and the business world. Tax is a compulsory contribution by the people who availed any benefits in the process of economic activity of the country. The taxpayer pays the tax for communal good of the society. As per “Kautilya and Chanakya” the tax authorities are required to collect the amount of tax from the beneficiary in such a manner that “Bees collecting honey from the flower without injuring the flower”. Or “Sun collects the water through its rays without troubling the inhabitants”. The main motto of taxation is to make an attempt in the equalization of have and have-nots on the principle of equity and distributive justice. The Kings like “Ashoka and Akbar” evolved a systematic taxation policy and also tax collection policy so as to earn revenue to run the kingdom without creating much hardship for the common man. Some kings had arbitrary tax collection system which they used to maintain their lavish lifestyles and wage wars. Today, in the modern economies, taxes are regulated by various rules and regulations and monitored by the people’s representatives. The revenue from taxation is a significant component of Government budget and higher the tax base, higher the Taxation Revenue. The public expenditure to a large extent depends on taxation revenue. Deficiency in taxation revenue lead to problems such as revenue deficit, budget deficit and fiscal deficit. These problems will contribute to slow economic growth and their by common man will suffer. Government needs fund for various purposes like maintenance of law and order, defense, social expenditures, health services, Education, infrastructure like roads, railways, metro, airport, dams etc. Government attains fund from various sources, out of which the main source is revenue from taxation.

INTERNATIONAL TAXATION SCENARIO

In **United Kingdom**, medieval time King John introduced an export tax on wool in 1203. In 1275, King Edward I introduced taxes on wine. In 1572, a Poor Law tax was established to help the deserving poor and then changed from a local tax to a national tax in 1601. In June 1628, Parliament passed the Petition of Right which among other measures, prohibited the use of taxes without the agreement of Parliament. This prevented the Crown from creating arbitrary taxes and imposing them upon subjects without consultation. One of the key taxes introduced by Charles II was to help pay for the rebuilding of the City of London after the Great Fire in 1666. Coal Tax acts were passed in 1667 and in 1670. The tax was eventually repealed in 1889. One of the key taxes introduced by Charles II was to help pay for the rebuilding of the City of London after the Great Fire in 1666. Coal Tax acts were passed in 1667 and in 1670. The tax was eventually repealed in 1889. In 1692 Parliament introduced a national land tax. This tax was levied on rental values and applied both to rural and to urban land. No provision was made for re-assessing the 1692 valuations and consequently they remained in force well into the 18th century. When the United Kingdom of Great Britain came into being on May 1, 1707, the window tax that had been introduced across England and Wales under the Act of Making Good the Deficiency of the Clipped Money in 1696, continued. Income Tax was first familiarized in 1799 in United Kingdom by the Prime Minister William Pitt the Younger, as a temporary measure to cover the cost of the Napoleonic Wars\(^2\).

In **America**, history of taxation begins with the colonial protest against British taxation policy in 1760s lead to the American Revolution. They placed a tax on common products imported into the American Colonies, such as lead, paper, paint, glass and tea. The independent nation collected taxes on imports such as whiskey and for a while on glass windows. States and localities collected poll taxes on voters and property taxes on land and commercial buildings. There are state and federal excise taxes, inheritance taxes began after 1900\(^3\). The United

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\(^3\) [https://en.wikipedia.org/wiki/Taxation_history_of_the_United_States](https://en.wikipedia.org/wiki/Taxation_history_of_the_United_States)
States imposed income tax concisely during the Civil war and continued up to 1890; on permanent basis from 1913⁴.

In Australia, The Federal of Australia introduced income tax in order to collect money from public and route the same for First World War in 1915. Between 1915 and 1942, income taxes were charged at both the state and federal level. When the first Governor, Governor Phillip, arrived in New South Wales in 1788, he had a Royal Instruction that gave him power to impose taxation if the colony needed it. The first taxes in Australia were raised to help pay for the completion of Sydney's first goal and provide for the orphans of the colony. Import duties were put on spirits, wine and beer and later on luxury goods. After 1824 the Government of New South Wales raised extra revenue from customs and excise duties. These were the most important sources of revenue for the colony throughout the 19th century. Taxes were raised on spirits, beer, tobacco, cigars and cigarettes. These taxes would vary between each of the Australian colonies, and this state of affairs remained in place after the colonies achieved statehood - indeed, it still persists to this day. Colonial governments also raised money from fees on wills and stamp duty, which is a tax imposed on certain kinds of documents. The Taxation Administration Act 1953 was assented to on 4 March 1953⁵.

In Canada, Personal income tax was introduced under the Income War Tax Act of 1917 like the other wartime taxes as a temporary measure. This act both expanded the scope of the Business Profits War Tax and introduced a tax based on yearly income to most Canadians. Unlike the United Kingdom and the United States, Canada avoided charging an income tax prior to the First World War. The lack of income tax was seen as a key component in Canada's efforts to attract immigrants as Canada offered a lower tax regime compared to almost every other country. Prior to the war, Canadian federal governments relied on tariffs and customs income under the auspices of the National Policy for most of their revenue, while the provincial governments sustained themselves primarily through

⁴ www.politics.co.uk/reference/income-tax
⁵ https://en.wikipedia.org/wiki/Taxation_in_Australia
their management of natural resources. The federal Liberal Party considered the probable need to introduce an income tax should their negotiation of a free trade agreement with the United States in the early 20th century succeed, but the Conservatives defeated the Liberals in 1911 over their support of free trade. The Conservatives (Tories) opposed income tax as they wanted to attract immigrants primarily from the United Kingdom and the United States, and they wanted to give immigrants some incentive to come to Canada.\(^6\)

Wartime expenses forced the Tories to re-consider their options and in 1918, the wartime government under Sir Robert Borden, imposed a "temporary" income tax to cover expenses. Despite the new tax the Canadian government ran up considerable debts during the war and were unable to forego income tax revenue after the war ended. With the election of the Liberal government of Prime Minister William Lyon Mackenzie King, much of the National Policy was dismantled and income tax has remained in place ever since.

Taxation in Japan is based primarily upon a national income tax and a residential tax based upon one's area of residence. There is a consumption tax and excise taxes at national level, an enterprise tax and a vehicle tax at prefectural level and a property tax at municipal level. The Liberal Democratic Party government of Masayoshi Ōhira had attempted to introduce a consumption tax in 1979. Ohira met a lot of opposition within his own party and gave up on his attempt after his party suffered badly in the 1979 election. Ten years later Noboru Takeshita successfully negotiated with politicians, bureaucrats, business and labor unions to introduce a consumption tax, which was introduced at a rate of 3% consumption tax in 1989.\(^7\) Till today Japan is revising tax rates to smoothening the economic development.

The above are the evolution of tax system in various continents of the world and the system of tax in India happens to be remarkable compare to the rest of the world.

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\(^6\) https://en.wikipedia.org/wiki/Taxation_in_Canada

\(^7\) https://en.wikipedia.org/wiki/Taxation_in_Japan
INDIAN TAXATION SCENARIO

Taxation in India is rooted from the period of Manu Smriti, Srimada Bhagavatam and Arthashastra. 2300 years ago, Kautilya described the system of tax administration which is remarkable and can be compared to the present tax structure across the world. He mentioned in Arthashastra the importance of tax collection, manner of tax collection and schedule of each payment. He laid down that traders and artisans should pay 1/5th of their profits in silver and gold, while the agriculturists were to pay 1/6th, 1/8th and 1/10th of their produce depending upon their circumstances. Kautilya also laid down that during war or emergencies like famine or floods, etc. the taxation system should be made more stringent and the king could also raise war loans.

In India, Income tax was familiarized for the first time in 1860, by Sir James Wilson in order to meet the losses continued by the Government on account of Military mutiny of 1857. Thereafter, several alterations were made from time to time. In 1918, a new income tax act passed and substituted by new act in 1922. This Act continued in operation up to the assessment year 1961-62 with time to time amendments. Income tax in India is administered by The Income Tax Act, 1961. To the present context, the act has become timeworn and modified several times. This has made the old act complicated and difficulty in interpretation lead to many disputes and court cases. The Indian tax system has been classified into three Tier, i.e., Center, State and the local bodies having powers to levy variety of taxes to earn revenue. The different types of taxes collected at different levels are direct tax such as Income tax and wealth tax which affects the common man directly and indirect tax such as VAT, Service tax, Excise duty etc., which affects the common man while acquiring goods and services. The common man wishes the income tax slabs to be raised, while the corporates wishes tax relief on various sectors. Government handles these requests according to the economic situation. Over the year, India has experienced unprecedented rates of economic growth. To stabilize economic growth, it requires reform in the taxation system to make it simpler and attractive for the domestic as well as foreign investors. To keep intact with the changes in global economy, Indian taxation system has undergone
remarkable reforms during the last two decades with rationalization and simplification of laws.

The age-old question is, what is the optimum rate of tax, mode and system of tax collection in India? Whether the poor and rich have been equalized on the basis of collection and distribution of tax revenue? Whether the cannon of taxation are systematically followed by the successive Government? Whether the legislature and taxation is flexible enough to meet the rapid changing world scenario? What are the loopholes in the existing taxation Structure and System? How to move from complexity to simplicity in the taxation system of India? Whether the proposed Direct tax code and designated implementation of Goods and services tax (GST) from 2017-18 will act as Panacea for all the battle necks of Indian taxation system? These are the vital points and issues of the Ph.D Research Program.

1.2 TAX REFORMS IN INDIA

India is one of the largest and fastest emerging economies of the world. A sound tax system is vital for the development of the public finances of any country (Rao, 2000)⁸. India has been ranked among the top 4th attractive destinations as per 2014 report for inbound investments and world’s 3rd largest economy as per Gross Domestic Product in PPP terms. India is 2nd in the world, with more than 1.21 billion population (2011 Census)⁹, out of which 2/3rd of the population are in working age. It means that India will be a source of human Capital for the entire world and key positions will be occupied across the world in upcoming decades.

In any nation, mobilizing resources through tax reform serves twin purposes of having a rational structure and generating higher resources in an equitable and efficient manner. The Tax reforms are one of the important economic development policies which shapes the Tax Structure on par with the bench mark of rest of the world. In recent times, it has been observed that

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⁹2011 Census, Public Financial statistics report,
globalization is one of the reasons of reforms in tax system. The motivation for these reforms are different from one country to another and the thrust of reforms has fluctuated from time to time depending on the development strategy and philosophy of the times. In developing countries, the immediate reason for tax reforms has been the need to enhance revenues to meet impending fiscal crises. As Bird (1993) states, “Fiscal crisis has been established to be the mother of tax reform”. Such reforms, however, are often ad-hoc and are prepared to meet immediate exigencies of revenue. Most of the cases, such reforms are not in the nature of systemic improvements to enhance the long run productivity of the tax system. Indian states derive approximately 65 percent of revenue from own sources, the remaining 35 percent being the transfers from the centre. Over the years central transfers to states as ratio to GDP stagnated and consequently, in view of the growing expenditure needs the dependency on own revenue increased. However, the growth of own tax revenue of almost all the states has been on the decline which has aggravated the pressure on the fiscal balance in course of time. It leads to decline in the quality of expenditure. There is also a need to adjust the taxation to suit the needs of growing market orientation to the economy which calls for reducing the tax differentials across the states, broadening the tax base with minimal exemption and incentives, bringing the much needed transparency for better tax compliance.

Indian taxation system has always been under criticism because of number of defects in the present tax system such as complex nature of taxes, multiplicity of taxes, more dependence on indirect taxes, problem of tax evasion, frequent changes in tax rates, narrow base of the taxes etc. considering all these defects there is an urgent need of tax reforms in India. In this tune the government of India appointed various committees from time to time for making recommendations to improve the existing tax system i.e right from Taxation Enquiry Commission (1954), One man Committee Nicholas (1956), Direct Tax Administration Enquiry Committee (Mahavir Tyagi Committee 1958), Bhoota Lingam Committee (1967), Wanchoo Committee (1970), K.M. Raj Committee (1972), L.K. Jha Committee (1976), Chelliah Committee (1991), Kelkar Committee (2002). In this regard, the central government working on series of reforms by forming committee to put forth the
outcome of recommendations to strengthen the Direct Tax by bringing Direct tax code into system to overcome obstacles in existing tax system in India.

1.3 DIRECT TAX CODE

The New Direct Tax Code (DTC) will act as a substitute for existing Income Tax Act of 1961. It was tabled in parliament on 30th August, 2010 and amendments suggested by members were inculcated during monsoon session. In the budget session 2010, the finance minister Mr. Pranab Mukherjee obligated to bring the new direct tax code (DTC) into force from 1st of April, 2011. But, the political chaos postponed the same until the next budget session on 16th March, 2012. In the budget speech for 2013-14, the Finance Minister perceived, “The Direct Tax Code (DTC) work is in progress. The DTC is not anticipated to be an amended version of the Income Tax Act, 1961 but a new code based on the best international practices that will be compatible with the needs of a fast developing economy. There is a requirement for every individual to be well knowledgeable about these changes so that their entire investment portfolio in a manner that is both tax efficient and allow them to successfully achieve their life time financial goals. The chaos continued up to 2017 and ended up in terms of seizing the concept out of system. The new tax code is anticipated to widen the tax base, end unnecessary exemptions, moderate tax rates and enhance to the government’s coffers. Government is having an impression that new Direct Tax Code will help them to improve the tax to GDP ratio significantly. It also aims at simplifying the laws, smoothening the entire process of tax collection and improved overall compliance. If DTC implemented in to the system the government will not interfere with tax rates every year, so as to provide a greater degree of tax certainty to corporate, investors and individuals. With the introduction of the new DTC, the tax rates will not be a part of the annual budget.

The Present Government insisting on restructuring the prevailing Tax System instead of implementation Direct Tax Code. It is better to bring reforms in the entire Tax structure rather than meddling at the corners. It would be far better if the government even now decides to go ahead with the original version of the DTC as it is a best way to reform the Indian tax structure. The economist will say that a clean
tax code results in more efficient capital allocation in an emerging economy. The tax consultant will know that it can dramatically reduce tax terrorism by undermining the discretionary powers of the tax department. It is also worth pointing out that a complicated tax structure in effect helps large business groups who can game the system with the help of a battery of in-house tax experts. The DTC will actually help to increase the tax base to deal with the problem of potential revenue loss\textsuperscript{10}. Thus, it is very important to accept DTC architecture. The government can accept Direct Tax Code parallel with Goods and Service Tax (GST) to strengthen Indian tax system. In this Context the present study is focusing on the tax reform in India potential challenges with special reference to Direct Tax Code and its relevance on Indian economic development as a whole.

\textsuperscript{10} http://www.livemint.com/Opinion