Rural Management - Taxation

Rural Management
Taxation

First Edition

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Editorial Board

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About the Book

Taxes are a transfer of income from the people to Government backed by the functions of government to defend, administer and develop the Economy for the well -being of the people. It is an interesting hypothesis that urban India pays more tax than rural India because Agricultural income is exempt from income tax. The consumption of rural India is more need based and comforts and luxuries are less used than in urban areas. Tax avoidance and tax evasion is more possible in rural India. This is because Zamindari system is abolished in 1956. The tillers of land are mostly small farmers and landless marginal farmers who are tenants or labourers. Land records are muddled and under litigation. The payment of GST could be perceived to be low as the commodities consumed are mostly need based and subsidised. That is why, there was a call for 'Rural areas with urban amenities'. There is urgent need to think of rural community in the direction of developing the economy. Introducing Aadhar for identity and bank account for all was a great move in the context. There are great evaders of taxes hidden as absentee Land Lords.

With the scenario stated above, there is also extensive migration away from rural areas to urban areas much more than reverse migration.Rural infrastructure needs improvement. Employment programs and subsidies to support rural population below poverty line have started immediately after independence and continued to this day. So public expenditure on rural management is very significant. Therefore, there is urgent need to develop taxable capacity among the rural population. When a person below the poverty line gets to be enabled to the extent of paying tax, one feels a sense of pride and self -esteem. All stakeholders in an economy-the corporate, civil society and high net worth individuals along with the rest of the world led by the Government needs to think of developing this capacity through knowledge of taxation, components and procedures in taxation. This book provides this vital understanding which can be developed further towards greater pursuits through other sources of knowledge and expertise inculcation. Rural community may feel the need to become taxable if they understand the whole world of taxation. This book is an effort towards this goal.

I thank Dr Rekha Jagannath, Founder Member, Karnataka State Planning Board for contributing to this book and for her outstanding insights. Also, I would like to thank MGNCRE Team members for extending their extreme support in completing this text book.

Dr W G Prasanna Kumar
Chairman MGNCRE

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Chapter 1 Taxation

Introduction

People function best when they are left free to themselves because they are guided by 'self interest' which delivers best results in economic pursuits according to Adam smith the father of Economics. He therefore advocated 'laissez-faire (French word meaning 'let us alone') policy' already propagated by Physiocrats who were his predecessors in economic thought. Though he is a social animal, man does not only pursue self- interest but gets to be selfish and acquisitive. This disturbs social harmony and distributive justice. Further, great advantages of human interdependence against social isolation were revealed through civilizations. This, as Plato says in his 'Republic' state was born out of needs of mankind that no one is self-sufficing but each man has many wants. People live exchanging goods and services among themselves in a territory and forming a body of inhabitants called the state. For the state to function in a normal way, they have to be protected adequately from conflicts among themselves and against attack from external sources. There have to be agriculture and industries to produce goods and services have to be provided to communication and information for the people. Goods and people have to move. Therefore, three sectors namely agriculture, industries and infrastructure were formed and the sectors have to be governed by the state.

Objectives of the Chapter

- To explain the rationale for collection of taxes
- To enable comply with the tax levied
- To familiarize with the meaning of taxation
- To provide insights on the types of taxes levied on people
- To familiarize with the principles of taxation

Chapter Structure

1.1 Need for Taxation

1.2 Sources of Public Revenue

1.3 Meaning and Nature of Tax

1.4 Canons

1.5 Principles of Taxation

1.1. Need for Taxation

State performs relevant functions which affect all people. It confirms on external security against attack from out of the border. Economies like India which is a peninsula having land on three sides and water on one side, external security and vigilance is very important. The Government has to deeply air force, army and navy. They need to be deployed during uncontrollable civil disorder. Salary has to be paid to all the employees in these security forces. Arms and ammunitions have to be purchased. Administrators and technicians have to be employed. They have to be given accommodation and their families have to be given facilities. So, it has to incur expenditure on armed forces, navy and air force. It has to maintain internal civil stability. India has a large population with federal structure. It has a society with multiple languages, religions, rural and urban divide, literacy and gender divide and complex attitudes. There is high tendency of conflicts among people. There is also extensive internal migration among the states and immigration from rest of the world for education, occupation and socio-psychological and cultural needs. Therefore, police forces have to be employed from local, district and to state level.

State administers the three sectors namely primary sector consisting of mining and agriculture, industries and tertiary sector which constitutes physical infrastructure like transport, communication. Social infrastructure like education and health are also included in tertiary sector. Information technology, mobile technology, internet, media are all included under infrastructure or tertiary sector.

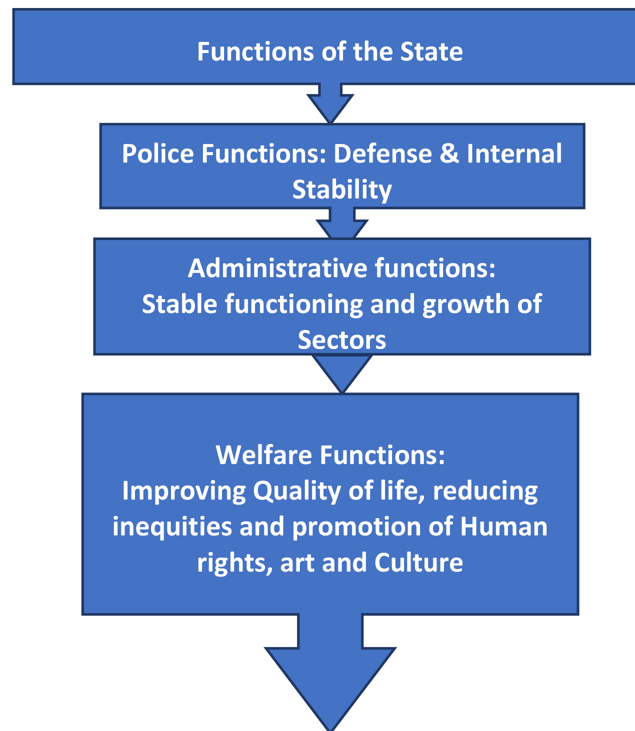

Figure 1.1 Need for Taxation

Growth of the sectors has to be monitored and directed as per the main aims and objectives of the economy mainly given in the constitution and in built in the minds of the people of the nation through

times. These sectors are provided infrastructure in the form of transport and communication. Raw materials have to be moved to the place where industries are located. Agricultural produce and industrial products have to be moved to the market. Information about the sale and price has to be communicated to the people and producers. Government has to initiate and monitor these sectors and their growth and development. There is growing need for funds. Government is not a producer and so it derives this amount from tax and non- tax revenue.

All States are now welfare states. So, redistribution of income to meet the inequities not met by private sector is a major responsibility of the state. So, they have to alleviate economy from poverty. This needs employment provision to those who cannot be generated employment and income by private sector. Public utilities like public libraries, public toilets, public schools and colleges, general hospitals, roads, railways and shipping have all to be constructed and maintained as and when private sector fails to do the same. Large amount of funds is required for this vital function. Government garners this through non-tax and tax revenues. For example, when India became independent, most of the villages did not have electricity, roads between each village and connecting villages and cities Railway lines and locomotives were built and connected villagers to the markets for their produce. Huge and ever-increasing need for funds of this function, leads Government to collect tax and non- tax revenue.

To Do Activity

1. Form students into groups
2. Ask them to collect magazine and newspaper cut outs showing what work Government does.
3. Make them present before the class
4. Do debriefing

Could also take students to local or state Government offices. Ask them to record what work the Ministers, Secretaries, Mayor and Corporations do. Do debriefing in the class.

1.2 Sources of Public Revenue

The points from where the state collects funds for its needs are called sources of public revenue. They are evolving in nature and content with the growth and changed in the nature and functions of economies. During Europe of medieval times, there was argument for a single tax system. Now all economies have multiple taxes. In India, taxation has not been a favored source of income for the rulers, in traditional India. Least tax principle and maximum social advantage were adhered to, in ancient India. Clear emergence of revenue system is accredited to Sher Shah Sur. Akbar of Moghul dynasty is accredited to have made revenue systematic with his vassals.

To Do Activity

1. Ask students to explore stories of tax collectors exploiting people during ancient exploitative kings and during British rule
2. Ask them to submit an assignment, make presentations and debrief
3. Students will find it interesting to browse and discuss the evolution of taxation in various countries in their peer groups.

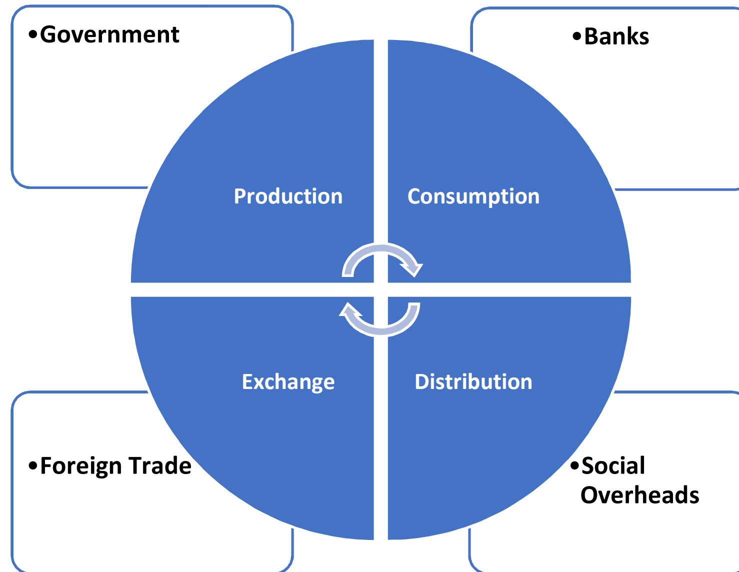

Figure 1.2 Circular Flow of Income

As seen in figure 1.2, national income is produced by firms. Households provide services to producers and get share of national income. They consume goods and national income flows as profits to producers. This is circular flow of national income as seen by classical economists. Other sectors support firms and households and derive national share of national income. Government is one of such sectors.

Government does not have its own funds to give salaries and wages to the manpower employed in delivering these functions and to pay for the material resources necessary for these functions. This is because Government is not a producer of revenue as a part of national income. Households and firms are producers. Producers supply goods through the three sectors primary sector, secondary sector and tertiary sector. Consumers demand these goods with the income they get from the producers. In order to mobilize income for the functions, therefore, government has to depend on collection of revenue from households and firms.

As Government functions for the well-being of the people, all over the world, taxes form the main source of Public Revenue. Governments try to tax least so that the people pay them willingly to the exchequer. It is often quoted from Physiocrats that “That Government is best which taxes least”.This is because, the amount of tax paid comes from the ‘pockets of the people’. Therefore, it causes a sense of sacrifice or burden when taxes are paid.Government cannot tax and please at the same time. When people pay taxes willingly (comply), it means that they accept that the Government contributes to their well -being (though by definition, no direct benefit can be claimed for payment of taxes).

Present Government’s move of extending GST payment deadline and income tax payment deadline considering covid-19 pandemic effects, is an indicator of a welfare Economy’s move of bearing burden of the people during emergencies.

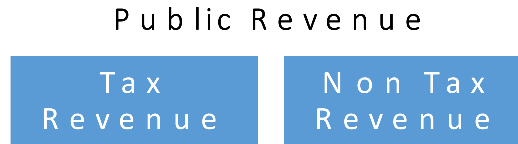

Figure 1.3 Sources of Public Revenue

Tax revenue is the most common source of revenue to the state in most of the economies of the world. It is this source that mobilizes highest proportion of revenue to the state. Taxes are compulsory funds collected by the Government from the people of an economy without any expectation of direct benefits (quid-pro-quo). Amount of taxes collected by Governments around the world has been increasing over time with increasing functions of the Government to promote growth and development of economies. The concept of taxes mainly bent on security functions which was the case in early rise of states is now declining. So, there are five aspects which form the nature of taxes which enable us to understand the meaning of taxation:

1. Taxes are paid to the Government: Government receives compulsory payment from the people to meet its functionary needs. That is, the public body may be local, regional or national public authorities collect taxes. The body that provides security to the people, administers the sectors of the economy as well as takes care of optimizing their quality of life and welfare.

2. Taxes are a compulsory contribution: Taxes have to be paid at the stipulated time and place. They have a deadline for payment. If a tax is not paid, it is a fault and such an entity is liable for punishment.

3. General contribution: Taxes are levied on all the residents of the state. They are a common collection from the people of an economy.

4. Taxes are paid by the people: All people who live in a territory should pay taxes to public authorities. They are paid in the form of money accepted in the economy by the individuals in the house holds and the corporate. These people may be farmers, artisans, craftsmen and small firms getting income in the economy. Here 'people' means those who are born in an economy and reside in an economy for a specific period of time have to pay taxes to the public authority.

5. People cannot expect any direct benefits/'quid-pro-quo' equal to the money they pay as taxes to the government. Government is not bound to give equal proportion of returns to people who pay taxes. There is no relationship of exchange or mutual benefit between tax payer and tax receiving authority. 'Quid pro- quo' is the legal word for 'direct benefits'. This nature of tax distinguishes it from other sources of public revenue; particularly fees which is also compulsory payment equal to the service rendered to the individual. Experts have tried to define taxation with slight variations in their opinion:

Hugh Dalton a traditional tax expert, in his 'Principles of Public Finance' defines a tax as "compulsory contribution imposed by a public authority, irrespective of service rendered to the tax payer in return". He has emphasized the above nature of taxes in his definition.

Plen in his book 'Introduction to Public Finance' defines a tax as "a general compulsory contribution of wealth levied upon persons natural or corporate, to defray the expenses incurred in conferring common benefits upon the residents of a state". Plen has more details into the nature of taxes compared to Dalton. He stresses on the status of people that it is levied on residents of a state. The people who live in an economy have to bear taxes.

To Do Activity

1. Students can be shown tax document and explained how tax is important.
2. Any commodity quote or receipt can be shown and tax component can be observed, introduced and discussed.

Non- Tax Revenue: State collects funds called 'public revenue'. There are two sources of revenue mainly tax and non-tax revenue. Non- tax revenues are all charged directly in proportion to specific functions of the Government. They are in the form of fees, license, gifts, grants, public property, duties, public debt, price, fine, tributes and indemnities, escheats, forfeitures, rates and special assessment. Tax revenue, fees as a non- tax revenue mop up high revenue from the people.

1. Fees: Next only they are compulsory charges imposed by the state, on the people for rendering specific services. They are levied exactly in proportion to the value of services rendered. Services by the state have to be equal to the fees paid. There is direct quid- pro- quo unlike taxes. For instance, electricity bill, school fees and college fees. When private sector is not sufficient to deliver services to needy people or when Government needs funds, Government intervenes to deliver services and collects fees as the cost of such service including fair profits or no profits to Government. When services are rendered by the Government without collecting fees they are either subsidies or grants in aid. If people have to pay to Government without expecting services, they are taxes, philanthropy or fine.

2. License: Government collects large amount of non- tax revenue through license. With importance given to economic growth in economies of the world, revenue to Government from license has been increasing. It is the compulsory charge collected from the people for permitting to start businesses. Firm, trade or enterprise. Without this permission no individual or firm can start any business. If a rural artisan has to start a toy industry or a ceramic product firm or a pottery industry or a foot wear firm, to sell the products, he has to take license. License is imposed to exert state control over certain activities of private entities.

3. Price: Like private sector, when Government produces certain goods, it fixes price to meet the cost of production and fair profits and sells the products in the set market. Normally, strategic and key sector goods like armaments production, key industry needs like iron and steel, cement, locomotive production, aero plane production, and ship building are atomic energy products produced and sold by the state for a price. Whoever buys the goods gets to pay the price.

4. Special Assessment: If a property is created and has special benefits of public services, the property owner has to pay 'special assessment' which is equal in value of the special gains for the value of the property due to public service. For example, in a very backward area of a village or a city, if road construction increases the value of the village properties around the road, the owners of such properties have to pay special assessment. It is paid only by those whose property value increases due to the new public utility in the vicinity.

5. Grants: These are funds extended to the state without any expectation of returns, but with expectation of executing certain objectives. It may be by from countries or international bodies. It may be by individual philanthropists. Grants do not have any expectation of monetary returns. But the objectives are to be implemented as per the specifications of the 'grant' obligations. For instance, a millionaire business man {like Premji of WIPRO} might extend grants to build rural schools with a given number of computers with internet connection, a digitized library and a playground in a specific number of villages, the granting entity will monitor and inspect till finish and after that for a specific number of years. Bill Gates and Melida Gates Foundation and UNSCO funds some economies to build a particular number of village hospitals with tele medicine and digitized medical registry in addition to a specific number of departments with specific infrastructure like heart facility, cancer facility, children's' Specialists, maternity etc.

To Do Activity

1. Give individual assignments to students to identify grants, philanthropy, good and bad effects of grants
2. Form them in to groups and provide them time to discuss and come up with few points
3. During debriefing session, ask them if they have received grants or collected grants for others

6. Escheats: They are duties levied on transfer of property from a person after death to another person. It is collected by local bodies.
7. Gifts: These are non- tax revenues given for good will from individuals and economies to the Government. It may be in the form of funds or in real form. Infosys has gifted some number of Sulabh Toilets to the Government. Some Companies may gift traffic Sign posts to the State. Canada has gifted some hospital equipment to India. Germany may gift a specific number of electric Volvo buses to Government of India to be run between specific villages and nodal cities to market their products. So also trains on certain rural routes may be gifted by Companies to the Government. Here executing certain objectives is the expectation from the donor and not money.

8. Fines/Penalty: It is a levy imposed by all/any levels of Government to stop or deter people from doing certain wrong deeds. It may be fine on traffic rule violation, fine on trespassing into some personal or confidential property. If a rural boy offers peanuts to monkeys or food to tigers in the zoo he is liable for a fine. If you throw water bottles or litter in a public park it is liable for fine in case of fine collection of funds is not the objective. It is to stop wrong behavior. However,

some funds are collected as fine. It is said that after digitized traffic signals and CCTV at traffic signals and connecting them with mobile numbers of vehicle users, large amounts are collected amounts are mobilized from defaulters.

9. Stamp Duties: They are collected on certain legal transactions between two parties. The amount of funds collected by this source was less than the administrative expenditure on it. So it is largely given up as a source of public non- tax revenue.

10. Octroi and Tolls: There are some regional Government collections like Octroi and toll for movement of men and materials between one area to another. They are levied with specific advantage to the people in business. Compulsory amount is collected.

To Do Activity:

Discuss on how Government should collect funds

1. Give group assignment to identify how famous kings of India got funds to take care of people and also how Alexander collected funds for his battles to become an Emperor.
2. Make them do group presentations in brief.
3. Students can enlist what changes present Finance Ministry has initiated in taxation and if they increase or decrease welfare.

1.3 Meaning and Nature of Tax

As human societies evolved, economic activities were made systematic and separated from other activities to enable efficient and timely delivery of variousfunctions. There were times when kings ruled the world when taxes were not imposed by the government! They were called as 'golden age 'such as the rule of Chandra Gupta of Gupta dynasty of India, Chandra Gupta Maurya of Maurya Dynasty and French King Louis XIV which was called Enlightened Despotism. In the process of evolution of 'state', taxes were imposed when there were wars and geographical emergencies. Otherwise, Government had its own estate or property from which income was earned, to enable it to function. But in modern Government, tax is the main source of annual income. People willingly pay taxes for the services of the government regularly. Such voluntary and accepted payment of tax regularly is called tax compliance. In rich welfare economies like Netherlands, Denmark, Sweden, Norway and other scadenavian economies tax compliance is high. Tax is a compulsory contribution to the Government from the people without expectation of any direct benefit. In an Economy house holds produce services and firms produce goods. But if their engagements in various sectors like Agriculture and industries haveto function smoothly, without disturbances they need security from external attack and internal crimes. Infrastructure like roads, telephone, Information and transport, social infrastructure like health and education have all got to be facilitated. There is need for men and material to provide this intervention to enable house holds ad firms to work continuously. Government provides this intervention. However, it needs funds to pay the services and establishment that it needs to function efficiently for the well being of people. Accepting the services of the Government, it is arranged that the people pay a portion of their income

towards the functioning of the Government. Small amounts are paid where ever goods are purchased which are termed as indirect taxes, now termed as Goods and Services Taxes (GST). People above a fixed level of income are said to be earning more than their needs. So all those who are earning such high income and those who gather property above a particular level may pay income and property taxes which are both called direct taxes.

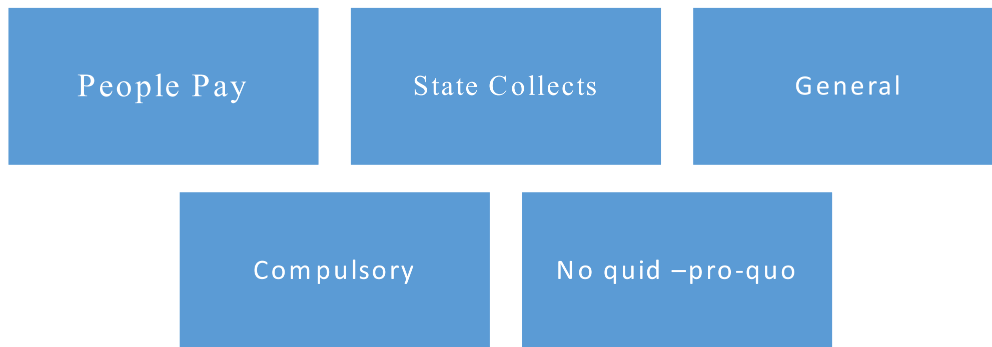

Figure 1.4 Concepts in a Tax

1.4 Canons of Taxation

Taxation involves people and the Government. People pay taxes compulsorily from their own funds without direct expectation of returns. So, it creates a sense of sacrifice and pinches them. Government collects taxes from people. So, it should create a sense of responsibility and accountability to the people about the funds collected there from. To provide this background to taxes and awareness among the parties involved in taxation, principles/canons of taxation are presented.

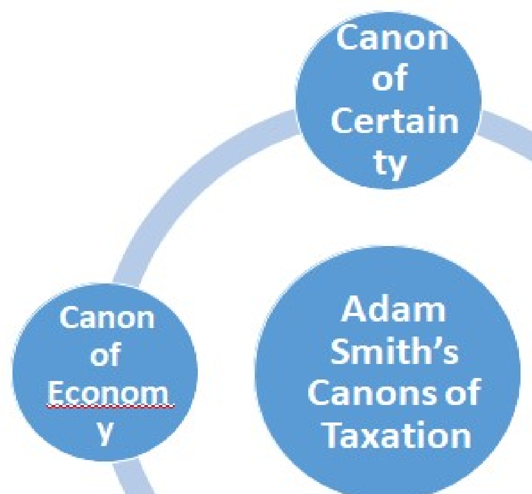

Figure 1.5 Canons of Taxation

They are a set of rules and regulations or philosophy behind imposition of taxes by the Government. They tend to enhance payment of taxes. Soalso, the people have to be aware of these principles so that

they are not unduly exploited by the government. From ancient times some principles were advised for taxation because they take off personal income of people. In Rig Veda it is given that a Raja should collect taxes from the people like bees collecting nectar from the flowers. (This statement has been quoted by Chanukya in his Artha Shastra) That is to say pain should not be caused to the people while paying taxes. They should pay without force or coercion voluntarily.

Adam Smith; often called the father of Economics gives four renowned canons of taxation:

1. **Canon of Equality**: It is the most popular canon of taxation largely debated also. It means that same amount and same proportion of personal income should not be charged on all the people. If so, the richest will sacrifice less towards the state. Low income group will be sacrificing more as their utility for money is more. So, such a tax tends to be regressive. It is stated that the subjects of every state should contribute to support the state as far as possible in proportion to their ability to pay. The canon of equity is interpreted in different ways. But mostly it is progressive taxation that is approved as its interpretation. It means that the proportion of contribution as tax should increase with rise in income. That is to say, the poorest should not pay any tax and they should be extended benefits in addition. The middle class should pay in proportion to their income and the high-income group should pay the highest proportion of their income as tax.
2. **Canon of Certainty**: He advises that taxes that take way income from the pockets of people, should be sure in terms of time of payment, place of payment and amount of payment. The time should be surely known to tax payers and receivers too. So that he can be ready for the sacrifice. The amount should be surely known so that the tax payer prepares to pay the amount by the time of payment.
3. **Canon of Convenience:** The amount, place and time should be convenient to the tax payer because he has to bear the monetary loss. Otherwise it leads to exploitation. Place of payment should also be convenient and near to the payer so that he doesn't incur more loss and face inconvenience to pay taxes. If the place, time and amount are not convenient it makes the process of tax payment difficult for the tax payer.
4. **Canon of Economy:** This canon states that as little as possible should be taken out from the pockets of the people and least should be spent on the administration of tax, but it should bring in maximum amount to meet the needs of the Government. Taxes should be levied in such a way as to meet the objectives of both people and the Government.

In addition to the above canons, modern tax experts have advised that Government and people should mind the following principles:

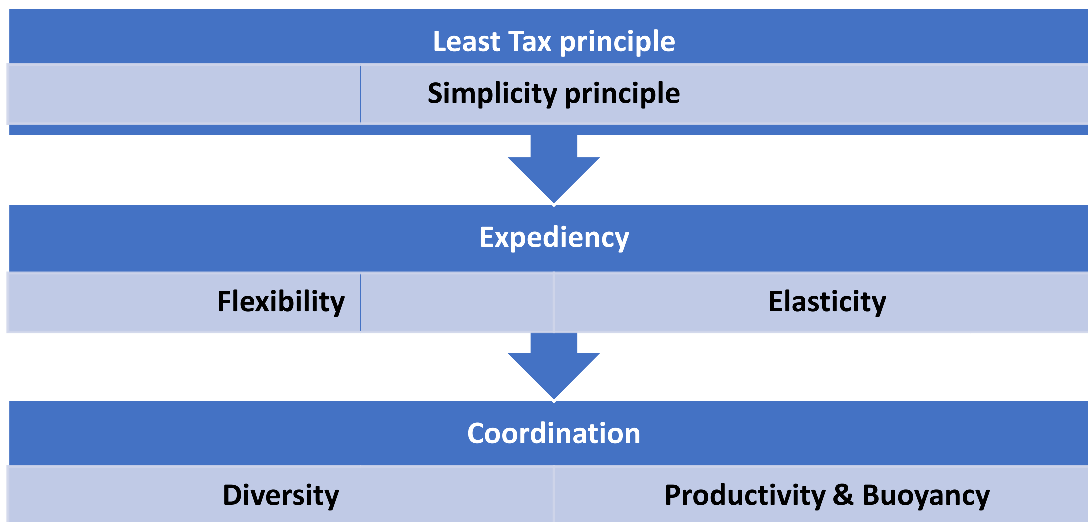

Figure 1.6 Principles of Taxation

Taxes should be levied with the principle of maximum social advantage or best possible benefit to the people is the ultimate aim. The revenue from taxation should be allotted for spending on areas that result in best possible benefits to the people. Taxes should be collected if they are necessary to be used for those functions that give best advantage to people like education, health and infrastructure in the form of transport and communication.

1.5. Principles of Taxation

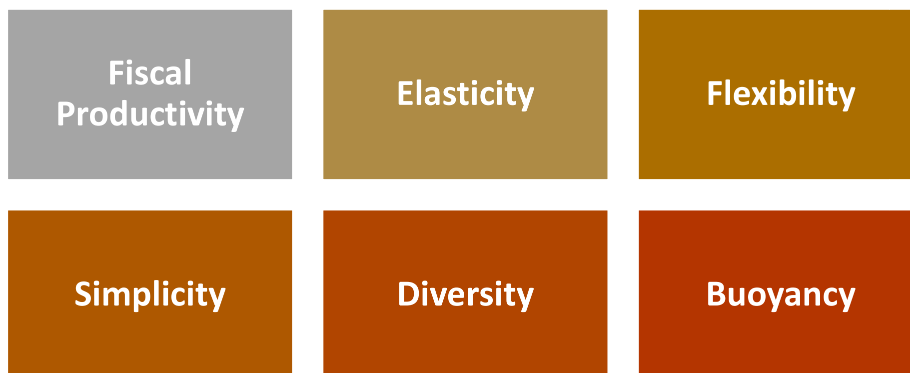

Figure 1.7 Principles of Taxation

Fiscal Productivity

Taxes should bring more revenue to the government compared to the amount spent on their administration to the Government and compared to the sacrifice of the people in paying them. This is termed as 'productivity' of taxes. Expenditure on tax collection and maintenance of tax accounts and on monitoring tax revenue is called as administrative expenditure. Administrative expenditure should be minimal and revenue generated should be substantially higher than administrative expenditure. If administrative expenditure is higher than tax revenue generated, such a tax should be given up. In India, death duty was imposed. The revenue generated was much less than the income it mopped up. So, the tax was discontinued. If people try to escape a tax over the years the government may levy a new tax that cannot be escaped.

Here Laffer curve could be studied. This curve inversely relates tax rates with productivity. This curve is popular in showing that higher the tax rates lower the productivity of taxes. The shape of the curve depends on the changes in tax rates and changes in tax yield.X axis represents tax rates. Y axis represents Tax yield. Gradual rise in tax rates are responded with rise in productivity. But after the maximum point shown in the graph, tax productivity declines if tax rates are increased. Indian tax rates are a case to prove the theory. Indian tax rates are high compared to a major proportion of sample economies in 'Doing Business ease' report.

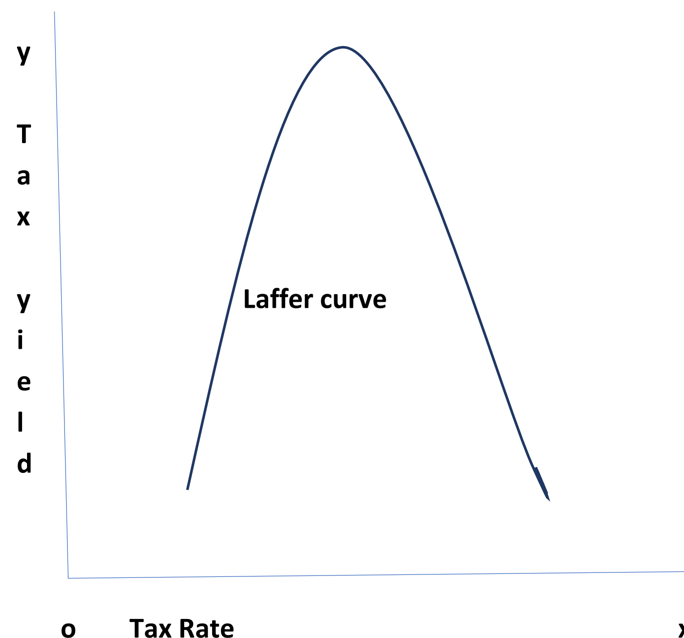

Figure 1.7 Laffer Curve

Elasticity

Taxes should be so framed as to increase and to be brought to previous level with changes in needs of time. Forinstance, when there is a war, capital levy might be imposed on richest capital owners to meet excess needs of war. There should be provision to remove the levied tax after war as the rationale for its

levy no more exists. If there is a tax on people of most developed states to provide needs of a specific number of backward villages, when the backward villages are sufficiently developed such a tax should be removed. In Indian federation, Union taxes are more elastic than state taxes.
Elasticity changes often lead to changes in tax productivity. Most of the studies in elasticity run the following measurement:

$$\frac{\Delta T / T}{\Delta Y / Y} = \frac{\Delta T}{T} \frac{Y}{\Delta Y}$$

It means change in proportion (%) of tax due to a change in proportion (%) of income is equal to change in proportion (%) of tax over the original tax compared to change in proportion (%) income compared to original income.
This is to say that, with the rate of change in income, if taxes change proportionately, tax is elastic. If change in tax rate is higher than change in income, such a tax is highly income elastic. If the change in tax proportion (%) is less than the change in income, tax is has low income elasticity.

In the above formula E represents elasticity, Δ Y represents changes in GDP (Gross Domestic Product or SDP (state domestic product) as the Case may and ΔT stands for change in tax rate in base period chosen.Income tax is said to be more elastic than property taxes and commodity taxes.

Flexibility

Tax structure should be such that it can be changed in proportion, mode of payment and in content. When there is need taxes should be increased and when the scope is seen they have to be reduced below normal. Sometimes they have to be retained in the same proportion. This is the perception of this canon. In Indian fiscal history, Agricultural income tax has never been levied. It is the most rigid premise. After economic reforms small degree of flexibility was added here by imposing tax on farm incomes. Soalso, corporate taxes were always maintained at the same high rate on the ground that the sacrifice of rich corporate is negligible compared to their revenue. The corporate often pleaded for reduction. Present Government has introduced flexibility for the first time by decreasing the rate of this tax to encourage corporate to invest.

Simplicity

As tax is levied on people, to enable understanding and they should be simple in wording as a document, the method of payment should not be complex too long and communication of tax officials should be simple. Common words and vocabulary should be used and complexities in communication have to be avoided. There should not be too many tax rates causing confusion. For example, Indian Central Excise now called GST was supposed to lack simplicity due to multiple tax rates for multiple commodities. Such cases lead to non-compliance, avoidance and longtime towards tax compliance.

Diversity

Taxes should be levied in such a way that the Burden of tax is not too high on the people. So small amount should be levied should be spread on large population. There should be different taxes on different taxable population such that more tax is collected in small amounts. Diversification of sources

of revenue: If many people and many items are levied small proportion of taxes people are found to pay willingly, instead of imposing large percentage of tax on one entity. If there is any group or sector which has more funds that can be used for the people, a new tax might be levied. It has the potential for new taxation.

Buoyancy

Changes in the tax yield flowing from modification of taxes parameters (like tax rates, bases etc.) are called discretionary changes.Automaticchanges in tax revenue are those resulting from variations in the economies' income.Buoyancy of a tax refers to changes in tax yield as a combined effect of both automatic and discretionary changes. Developing economies lack buoyancy of taxation.

International Comparison

In 2003, to measure and compare countries in about some of their 10 vital specific aspects of business over time, World Bank/International Bank of Reconstruction and Development (IBRD) initiated an annual report called 'Ease of Doing Business (EODB) Report'. The following report is for the year 2016 where Indian tax rate and time taken to comply with tax are given so that they are compared with other countries to know how good we are in doing business. Honest and timely tax payment is considered to be an indicator of good business practices in an economy.

Table 1.1 Comparisonof Tax Compliance in Different Economies

	Ease of Tax Payments: -(Rank among 189 countries): - Country Rank Secured in ease of Tax Payments amongst 189 Countries	GDP-Tax ratio	Time to comply with tax in hours	Total tax rate	Number of payments
India	157	17.7	243	60.6	33
USA	53	26.9	175	43.9	9
UK	15	39	110	32	8
SA	20	26.9	200	28.8	NA
Mexico	92	19.7	286	51.7	6
China	132	22	261	67.8	11
World	Not available (NA)	21.82	261	40.8	NA
Source: World Bank Data 2016					

Above table shows how India compares with other sample economies in terms of tax compliance terms of ease of tax payments which means the people feeling easy to comply (accept and pay taxes) with taxationIndia ranks 157th. India is behind China which ranks 132nd.South Africa which ranks 20th (excellent acceptance unusual among developing nations), Mexico which ranks 92nd (rather good ranking for a developing economy). USA is 53rd way behind UK which ranks 15th.Tax/GDP ratio shows percentage

of contribution of taxes to Gross Domestic Product (GDP). Indian taxes contribute only 17.7% to GDP. There is scope to mobilize more tax revenue. In UK 39%, that is more than 1/3of the GDP is contributed by taxes. In USA nearly 1/3 of the GDP that is26.9% is given by taxes. Interesting that South African contributes the same proportion of taxes to GDP as the people of USA. Mexico and China collect more taxes than Indians towards GDP. It has tobe noted that like Mexico and China, India is below world average of 21.82% in tax contribution to GDP. Indians take 243 hours to comply with taxes. USA takes 175 hours and UK takes 110 hours.SouthAfricans take less time to comply with taxes;200 hours, Mexicans take much longer than Indians to pay taxes 286 hours which is also longer the world average of 261 hours. Chinese are just at world average time in payment of taxes. India is only better than Mexico and China in time taken for tax compliance. In the given sample economies, China's tax rate is very high at 67.8%. Indian tax rate is also very high at 60.6%, next only to China. So, India has not much scope to increase rate to mobilize more tax revenue. It has to find other modes of greater tax mobilization like diversification of sources of taxation, innovative new taxes and encouraging more tax compliance. We have to note that developed economies have much less tax rates than India. UK imposes 32%; less than world tax rate of 40.8%. USA levies tax rate of 43.9%. Summary view is that India is faring badly as compared to other sample economies, in terms of all indicators connected to tax compliance taken up in 'Doing Business Ease' report.

To Do Activity

a) Ask students to volunteer to mono- act like Chanakya and Adam Smith and advice principles of taxation
b) Tell them stories of forceful collection of taxes

Stories of tax exploitation during Moghul rule or British rule may be asked to be read by students.

c) Ease of Doing Business Report of 2020 and Indian status can be discussed

Objectives of Taxation

State has some long term goals and targets while imposing taxes. Government may levy new taxes, change the nature of taxes and reduce taxes with some main focus like the following:

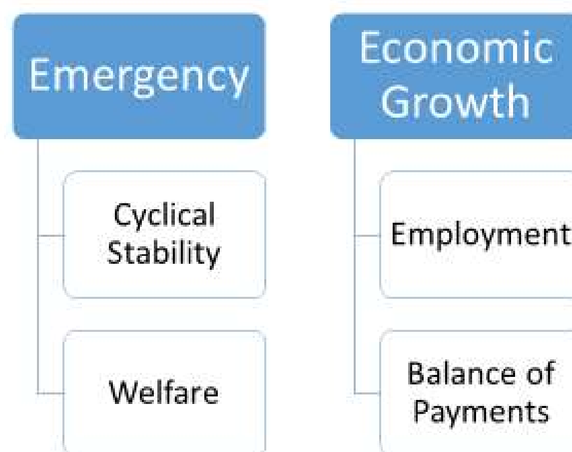

Figure1.8 Objectives of Taxation

1. Political or Economic Emergency

Taxes may be increased, decreased or removed due to these conditions. At present due to Corona, Indian Finance Minister has extended last date for payment of income tax of 2019 from 31st of March to 30th of June 2020. During the world wars and Recession of 1930s tax changes were made all over the world. If there is some urgent need for more funds due to war or natural calamities like famine or floods, there may be shortage of funds. Due to this there may be total rise in taxes. India has had Indo-China war in 1962 and Indo-Pak war in 1972 when more taxes were levied on the people. After wars also there will be shortage of funds that lead to more taxation. India has had famines due to which national income drastically fell. So, Government was in need of funds. Floods have been experienced in Andhra Pradesh, TamilNadu and Karnataka where people have to be rehabilitated by the Government. So, more collection of taxes from the people.

a. **Maintain Monetary Stability:** Control of cyclical fluctuations: For instance now we are experiencing slow growth, to increase growth rate, we need investment to encourage investment Government needs funds to give incentives to investors. So, it taxes higher profits or income or consumer goods to mop up funds. During recession, low reduction of tax rates is often resorted to spur up investment. This is towards greater employment generation to activate the recession ridden economy. At present startups and foreign investors are given tax concessions in India to encourage investment to ward of recessionary tendencies. It is expected to increase employment and flowed up by more consumption increasing liquidity in the economy. During inflation, to reduce the flow of money, Government, absorbs excess money flow through high tax rates. High discretionary taxes on inflationary sectors are increased. For instance, during 1990 December, high inflation was understood to be due to high fossil fuel price. So, in the years after 1991, tax incentives were given to users of alternative energy and investors in renewables.

b. **Tackling Poverty:** Welfare is the final aim of all economies of the world. Economic welfare hinges on quality of life. Incapability of meeting minimum needs of life; namely food shelter and clothing is poverty. Poverty reduction is therefore the primary task of the government. As it is

not profitable private sector will not be interested in this task. Tackling poverty is perhaps one of the most important aims of taxation gaining more and more acceptability in the international community. Taxable people of an economy are more willing to pay taxes to mitigate poverty. To reduce poverty, poorest people have to be given free food, free education and promise jobs for income for a minimum period of life which is called subsidies extended by Government. That is, when they undergo training and education for future jobs. Funds necessary for this function, are to some extent mopped up by the Government from taxes.

The proportion of elderly is increasing. Rural elderly are more economically dependent and so there may be tax exemption and incentives for elderly care centers.

2. Economic Growth

To generate income for the economy, agriculture and industries have to grow. They can grow only with good infrastructure to deliver quality products and services to the people. Only then good price can be claimed by producers to maximize profits. If income from agriculture and allied services and profits of industries rise, employment arises. When employment rises income is generated. Income is sent on consumption leading to higher profits. Thus, national income grows leading to economic growth. Government has to trigger growth where ever there is market failure and private sector doesn't dare to invest. When people fail to consume enough Government has to tax savings and reduce taxes on consumption so as to instill consumption and growth.

In most of the economies of the world growth has been the most important objective of taxation. India has the same situation ever since independence, as India was left in shambles after independence, with destroyed handicrafts and mechanized industries in a nascent state. Agriculture had to be modernized and infrastructure was to be built afresh all over the economy.After the Second World War, all economies increased taxation as growth was imperative for destroyed world economies. Indian direct taxes like income tax and corporate income tax are said to be among the highest in the world. Present government reduced corporate income tax for the first time.

To Do Activity

1. The teacher can show reports of various years' documents of tax collection
2. Give them an assignment asking them to depict the following:
   - graphs from media for changes in tax with growth
   - draw graphs showing change in tax revenue of one or more economies from 'world development report'
   - Sample income tax form and GST registration forms from web site
3. Visit to Income tax office to interact with officials and departments, visit farmers, industrial centers and Associations like CII and State industrial Associations and ask what all taxes they pay and do debriefing
4. Students may be asked to bring and discuss tax introductory aspects from Newspapers and magazines

a) **Employment:** Tax system in both developed and developing economies is often designed to promote labor intensive sectors so as to boost employment. This requires related taxation measures. One such measure would be to remove incentives to use of more capital in commodities. This will discourage use of more capital component in production. One such measure is to increase tax rate on the concerned commodity. Keeping in view the population of a country and fast growing labour force, tax incentives should vary directly in proportion with the labour input in the product. Laour intensive products hold be taxed lightly. In keeping with this principle, India has heavy tax incentives for Khadi, Handloom and handicrafts sector. Labour intensive sector carries tax concessions for R& D to promote it.Such tax concessions are extended to products made by women to provide employment for women as proportion of women in work force in India is low. People need to be given jobs during recession and when they are under poverty. Private sector with profit motive is not genuinely interested in employing people unless there is expectation of profits. It is the Government which has to generate employment to enhance well- being of people. Best way to generate funds for government has been indirect taxes (now GST). This is because it is hidden in price of the commodity. At present tax concessions are given to Companies for 'Corporate Social Responsibility' involvements, as they these involvements of the corporate compliment the tax aims of the Government like reduction of poverty, employment etc.

b) **Balance of Payments:** Balance of payments is the annual account of imports and exports according to double entry book keeping method. If imports are high, then the Government could levy taxes on them or resources that are involved in their production, to reduce imports. Substitutes to such products may be taxed less than before. If exports are high, exports revenue may be mopped up through taxes. There may be low taxes to incentivize exports. At present, due to climate change, economies may try to tax polluting industries like automobiles which use fossil fuels and give tax deduction to electric vehicles. So also, rural farmers producing organic agricultural products and medicinal plants may be given tax exemption. More taxes may be levied on chemical fertilizers due to climate change implications. So, farmers using fertilizers have to pay more GST. Customs are levied on imports. This is to discourage imports, so that import bill is restrained. India levied more than 120% of customs till economic reforms of 1991.

Many industries had to smuggle foreign components towards quality and lower price to customers. Customs Duties were reduced in one stroke to 58% in 1991 to encourage international trade towards globalization. India had endemic unfavorable Balance of payments till customs were decreased and tax concessions were given to IT exports. This brought in a miracle of improvement in balance of payments in India from 1991 for over a decade.

India and Rest of the World: Developed economies also have high tax rates for the richest. Americans often complain that American income tax rates are high. But tax revenues are spent on people though public expenditure there. Indian tax system has developed through ages. It is said that Sher Shah Sur and Akbar gave specific methods for tax collection by dividing their kingdom into revenue districts and appointing tax officers. British further reformed tax structure. Our tax system is a legacy of the British

colonial rule. Most of the world uses GST as a single commodity tax (indirect tax). But till recently, India had different rates of central excise and state excise for different commodities. GST was initiated by UPA-2 and formally introduced by the present Government. But it has to be reformed towards standardization of rates and simplification of procedures. If Indian taxes are not in line with rest of the world, it gets to be hard to transact international trade. To tackle it they will have to resort to methods to simplify difficulties called 'harmonization'. Time and resources will have to be spent on this. So, demand for our products is reduced. Therefore, it is essential to have a tax structure that falls in line with international ways.

Indian tax revenues show healthy features like rising trend over the years after independence and taxes are spread on a large population through commodity taxes and not imposing burden on only a small section of population. But we have unhealthy issues of tax evasion, rigid taxes rates, lop sided taxation, inequities in taxation and regressive nature of taxes and need for simplification and standardization. We have to pursue a long period of tax reforms.

Summary

State doesn't involve in the process of generating national income. Households and firms participate in the circulation of national income. Firms produce goods and households consume them and create demand for goods for producers to invest again. Households deliver services to producers and get income. Producers distribute income to consumers to consume and save. But Government has derived demand as it provides services to firms and households in the form of protection, administration and promoting wellbeing.

To meet these needs, Government collects funds through tax and non-tax revenue.Non-tax revenue is in the form of fees, license, gifts, grants, public property, duties, public debt, price, fine, tributes and indemnities, escheats,forfeitures,rates and special assessment.Tax revenue is in the form of direct and indirect taxes. It is also classified into Absolute taxes, Proportionate taxes, progressive taxes and regressive taxes. Practically in international trade taxes are classified into ad Valorem and specific duties also.

Tax revenue is most common and highest source of public revenue. People have to pay compulsory amount to the Government without any direct expectation of services of equal value called taxes. These taxes have to be backed by a set of values rules and regulations called canons or principles. Adamsmith gave first asset of canons namely canon of equity, canon of convenience, canon of certainty and canon of economy. Modern economists have added the canon of productivity, canon of simplicity, canon of diversity, canon of elasticity, canon of flexibility and canon of coordination. Economists have often stated that least tax principle has to be adhered to optimize tax revenue. Principle of maximum social advantage has been vehemently propagated by welfare economists.

Taxes are levied with the objectives of meeting growing revenue needs, to meet sudden emergency expenditure, to meet the needs of economic growth, to tackle cyclical fluctuations, to provide employment, towards poverty alleviation public expenditure and to meet international trade

requirements.

Model Questions

1. State why Government needs to tax the people of the Economy?
2. Mention the main sources of Public Revenue
3. Should the taxes remain without any change over time? why?
4. State the principles to be followed to optimize tax returns
5. Mention the sources of non-tax revenue.
6. How do you differentiate tax revenue from non- tax revenue?
7. Can millionaires demand favor worth of the amount of tax they pay? Why?
8. Define the concept of 'Tax'?
9. State any traditional Indian ideal to optimize tax revenue
10. State the canons of taxation given by Adam Smith
11. What is the principle of 'maximum social advantage'?
12. State the principles to be followed to optimize tax return

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Chapter 2 Concepts of Taxation

Introduction

It is necessary to acquaint with a few concepts of taxation to understand taxation in its detail without understanding these concepts, implementation of tax policy and payment of taxes. honestly would be difficult. But tax concepts are added and some of them are discontinued over time. Most of the taxes are based on common base around the world. This facilitates international trade and international investment.

Objectives

- To give a birds' eye view of some important concepts related to taxation like taxable capacity
- To explain absolute and relative taxable capacity
- To familiarize factors influencing taxable capacity and limits
- Tofamiliarize CSR and Taxation
- To explain the process of tax collection

Chapter Structure

2.1 Taxable capacity

2.2 Absolute and Relative Taxable capacity

2.3 Factors influencing taxable capacity and Limits

2.4 CSR and Taxation

2.5. Tax collection

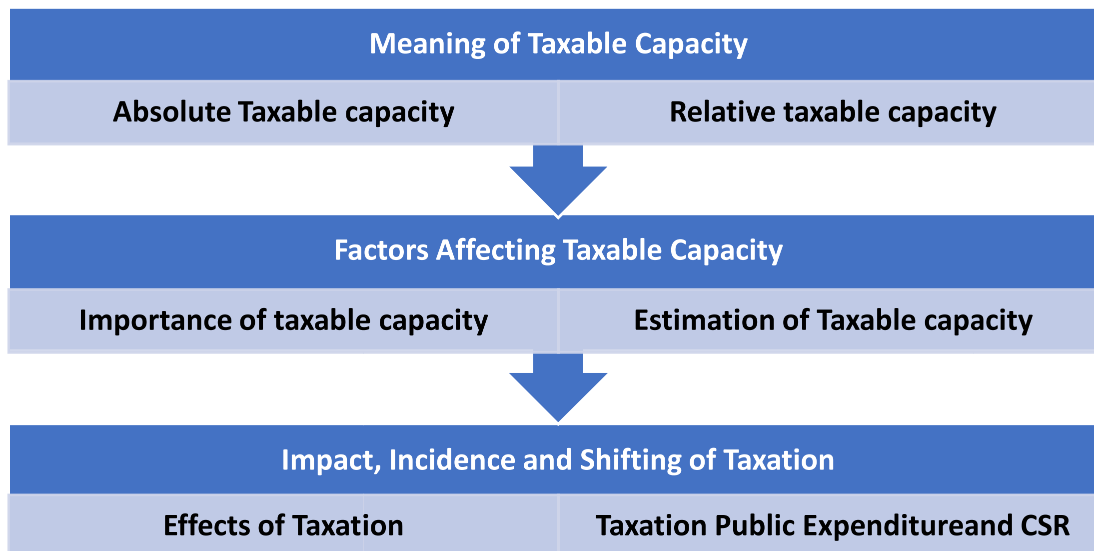

Figure 2.1 Meaning of Taxable Capacity

If tax concepts are not understood among economies, international trade and inflow and outflow ofmen and materials among economies gets to be more complex. Here it is tried to give an updated view of concepts. They are as follows:

2.1 Taxable Capacity

Modern states being welfare economies, there are increasing functions taken up in this direction. Increasing public expenditure in the recent years has enhanced welfare of the people and makes them happy. But taxation needs sacrifice of people's purchasing power. Therefore, very high rate of taxes are undesirable. The rate of taxation is often debated. Economies are trying to tax at the optimum rate as far as possible. The rate of taxes at which the welfare of the people is least affected, is tried to be reached. So, they it is tried to understand the limits of taxation. One of the main criteria that determines such a limit of taxation is taxable capacity. Higher the taxable capacity, higher will be the productivity of taxes. As long as the tax payer does not feel that that the tax is unbearable burden, he pays taxes. So, policy makers often contemplate into taxable capacity so as to get optimum tax returns. Though the meaning of taxable capacity is not accurate, they try to understand that limit of capacity of people to pay taxes beyond which they refuse to pay taxes! It is therefore in the interest of the welfare state not to cross the limit of 'taxable capacity'.

The term is of practical importance for the finance minister of an economy to mind 'taxable capacity' and keep tax rates below the 'taxable capacity'. If he increases tax rates above it, it is likely to generate widespread discontent among people, reducing tax collection of such a government.

To Do Activity: Students could be asked to search on the internet/communication technology (android) the name and definition of taxes on income, corporate profits, on capital gains, commodities, on exports and on imports in specific different economies of the world.

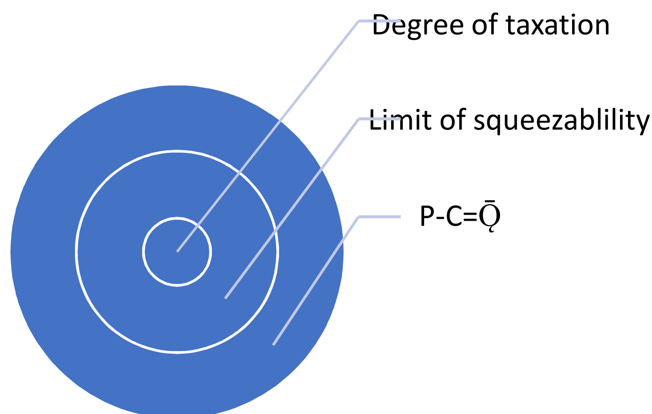

Figure 2.2 Taxable Capacity

Meaning of Taxable Capacity

Economists have defined the term in slightly varied way. Taxation Enquiry Commission of India (1954) says that "taxable capacity of a community may be said to refer to the degree of taxation. Broadly speaking beyond this, productive efficiency as a whole may begin to suffer". In this definition, stress has been given to the effect of taxes on productivity of human resources.Findley Shiras opines that "taxable capacity is the limit of squeezability. "It is the total surplus production over minimum consumption required to produce that level of production, the standard of living remaining unchanged".

Josiah Stamp defines Taxable capacity as "the minimum amount which the citizens can pay the public authorities without having a really unhappy and down trodden existence and without dislocating the economic organization too much".Prof. Musgrave defines taxable capacity as the "sacrifice that community is able to sustain".

To Do Activity: Students can be asked to collect information about Champaranya Satyagraha of Mahatma Gandhi and relate to taxable capacity of farmers there.

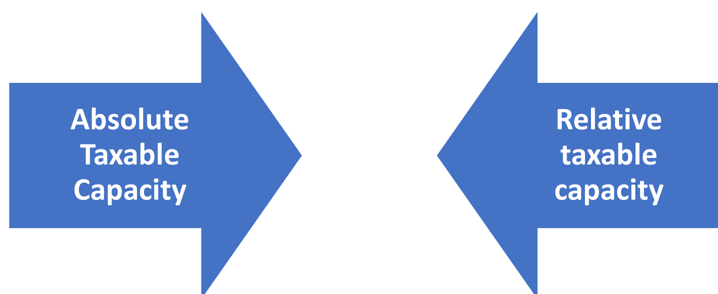

Figure 2.3Perceptions of Taxable Capacity

Above definitions show that **taxable capacity has two different perceptions**

2.2 Absolute Taxable Capacity and Relative Taxable Capacity

Absolute Taxable Capacity

Even this concept is seen in varied ways. Some look at it as capacity to pay taxes without to pay taxes without having to suffer. There are others who see it as the capacity to pay taxes in in spite of suffering. So, accuracy escapes definition of absolute taxable capacity. Exact amount of absolute taxable capacity cannot be stated. This is because it differs from one economy to anotherdepending on several factors influencing it. But approximately it is the maximum funds which could be collected without causing unpleasant effects, from a community. If implementing a tax causes unpleasant effects, absolute taxable capacity is said to have exceeded.

There are attempts by economists to measure absolute taxable capacity. Prof.Colin Clarke states that is most economies, absolute taxable capacity is 25% of national income. If any economy taxed above 25% of the national income, it will have adverse effects on ability and desire to save and desire to work. This statement of Colin Clarke is actually found to be true in developed economies than in developing economies. Thus, we have to admit that attempts to measure absolute taxable capacity are doomed.It has to be accepted that the amount notified as absolute taxable capacity is not fixed. For instance, in India absolute taxable capacity of IT sector is said to have increased after 1991. It changes over time and from economy to economy during a specific given time. In 1991 itself absolute taxable capacity of India was lower than absolute taxable capacity of Singapore which was first generation of economies implementing globalization

Relative Taxable Capacity

Itis the ability to pay taxes of two communities, towards a common element of public expenditure like different state taxes towards central Government expenditure in a federation. Relative taxable capacity is more practically understood. It shows how much a community can pay as tax beyond which they cannot pay tax. One state in a federation might be capable of contributing more share through the same tax to the exchequer. At the same time another state may find it pinching to contribute the same amount of funds. The total contribution of corporate income tax of Bihar is lower than the contribution of Pondicherry. This could be stated as relative taxable capacity of Bihar being less than Pondicherry.

The concept of relative taxable capacity is more definite, concrete and intelligible than the concept of absolute taxable capacity. It is that percentage or proportion of a that total expenditure of the economy which a community or people can allot for taxation at best as compared to another community or people. For instance, we state relative taxable capacity of Karnataka as compared to another state or to the entire Indian economy. We may state that relative taxable capacity of India is higher than Nepal or lower than USA. It shows the capacity of one community to contribute to total public expenditure for a particular purpose.

2.3 Factors Influencing Taxable Capacity

All the factors below lead to changes of an economy's ability to pay taxes. So, taxable capacity changes over time and from economy to economy. If one or more of these factors change, taxable capacity fluctuates. If all these factors remain stable, taxable capacity will be constant.

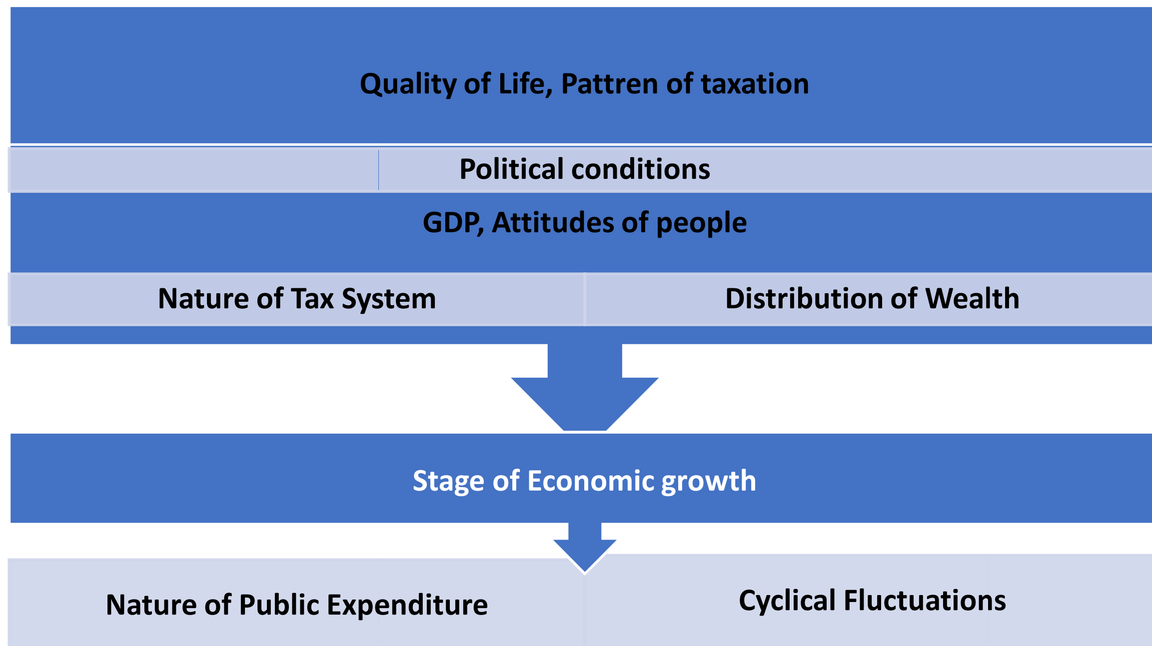

Figure 2.4 Factors affecting Taxable Capacity

- **Quality of Life of the People**: The term refers to the basket of goods and services an individual buy with his given personal disposable income (personal income after all taxes) of people is high, it is assumed in economic sense, and quality of life is high. After economic reforms of 1991 investment increased multifold, employment and personal income increased. Consumer expenditure increased and this showed increase in taxable capacity. Income in villages also increased due to Agri- business consortium, e-choupal of ITC, Corporate social responsibility (CSR) activities in rural areas, KrishiVikasKendras and use internet and communication technologies (ICT) in rural areas increased for health and education also. Tax collection during the period is recorded to have increased multifold.

- **Pattern of Taxation:** Well-planned structure of taxation with a suitable mix of direct and indirect taxes attracts higher taxable capacity. Diversification of taxes to impose less tax on each entity while larger population pays tax will collect high total revenue because taxable capacity is high as it suits the ability to pay of different income groups of people. If some potential sections of population are left untaxed, taxable capacity gets to be lower. Here Indian Agricultural income being untaxed is referred often by experts.

- **Political Conditions:** Stable functioning of parties, and governance with well planned and executed policies for economic development and welfare of the people enhance confidence in the minds of the people about their living conditions. Good governance with internal security and absence of civil strife create environment for stable life of the people. So also be able to organize and administerdefense in the form of strategically enabled army, air force and navy guard people from external attack. This encourages people to pay taxes on time periodically. If there is mal functioning of police force, internal civil disturbance with high crime rate and insecure social atmosphere, there is unrest among people.

- **Attitude of Tax-Payers:** This is an important factor. If people are unwilling to pay taxes, taxable capacity is low. Attitude of people may have positive influence on taxable capacity, if the revenue collected through tax is spent by the Government on infrastructure industries and agriculture. If administrative expenditure is high and corruption is high in the government, taxable capacity is definitely low. Scandinavian countries have high taxable capacity due to this reason. India has low taxable capacity owing to this factor.

- **Nature of Tax System:** The term tax system refers to the administration of taxes and procedures/methods of taxation. If tax system is well designed and has correct, simple, transparent and convenient procedures of taxable capacity is higher. Due to this reason, taxable capacity of New Zealand, Switzerland, Sweden and Denmark is higher when compared to India.

- **Distribution of Wealth:** Equitable distribution of income and wealth brings more people willingly into tax net. Taxes can be spread over a large population in the form of commodity taxes. It also reduces the tax revenue necessary for public expenditure in the form of subsidies. India has high potential to increase taxable capacity if there is fairer distribution of income or redistribution of income through state intervention.Some economists opine that unequal distribution favours higher taxable capacity. This is because Government can conveniently raise more tax revenue from a small number of rich in the economy. According these economists, equitable distribution of income and wealth does not favour high taxable capacity. This is due to the high ability to pay taxes among the rich compared to other income as classes.

- **Stage of Economic Growth:** Developed economies have higher taxable capacity than the developed economies due to higher national income. The same economy has higher taxable capacity when it moves from developing stage to developed stage of economic development.

- **Nature of Public Expenditure:** If the Government of a country makes good use of tax revenue collected, for development of the country, welfare of the people through health and education infrastructure, like general hospitals, Public libraries, partial and complete subsidies to face exigencies of life, then people are willing to pay higher taxes. This is well evidenced in Denmark, Norway and Sweden where people comply with taxes and taxable capacity is high. If public expenditure is irresponsible and unaccountable, there is higher tax evasion and avoidance. This is seen in India.

- **Cyclical Fluctuations:** Taxes are paid from the pockets of the people after consumption expenditure. During recession, prices of goods are low. So taxable capacity of common people is higher and indirect taxes are collected in greater proportion successfully. But the profits of businesses are low. So potential to pay direct taxes is low. During inflation when prices of goods and services are high. Businesses can pay higher direct taxes. But commodity tax payment capacity declines. For instance, in 1990 there was double digit inflation in India. During this period there was rampant tax evasion and high economic offences. Taxable capacity showed woeful decline due to inflation.

- **Population:** As the number of inhabitants (population) rises naturally taxable capacity rises, other factors remaining constant. Considering this factor India has good potential for higher taxable capacity as the economy develops, over time.

- **National Income:** With the rise in national income, per capita income rises. So, capacity to pay taxes also rises. Taxable capacity of India has increased after independence with rise in economic growth.

Frequency of tax evasion, money laundering and parallel economy is high. This is due to the faith of the people in the governance being shattered. Result is that taxable capacity recedes. It is observed that countries like Switzerland, New Zealand, Canada, Denmark, Finland and Luxemburg have high taxable capacity while war torn and crime ridden economies of Africa and South America, Pakistan have low taxable capacity due to this factor. In India itself, people are found to be showing high taxable capacity after independence then during exploitative British colonial regime.

Objectives of Taxation

If the objectives of taxation are economicdevelopmentandwelfare people see accountability of governance and taxable capacity is high. In such cases taxable capacity is even stretched beyond their normal capacity to sacrifice income. If government spends funds on fighting natural calamities like floods, famines or draught, expansion of education expenditure or health expenditure, there is excellent expansion of tax collection due to high taxable capacity. But if there is frequent and excessive public spending on administrative expenditure on expansion of bureaucracy, foreign visits of administrators and ministers or maintenance of foreign armed forces people experience a sense of excess burden and taxable capacity suffers. India has seen the above stated situations of decline and increase of taxable capacity.

Stability of Income

If people have stable income, they are ready to pay taxes and so taxable capacity is high. If income is unstable, people cannot be sure of future income and they will waver in paying taxes. Taxable capacity tends to be lower. Due to afore said reason, in developed economies with growing industries and commercialized and insured agriculture taxable capacity is high. In economies with frequent war with neighboring economies or those experiencing natural calamities often, taxable capacity is low.

If taxes are forcefully collected during such situations, faith in the government is lost and taxable capacity declines. British colonial Empire in India, collecting taxes during natural calamities from distressed Indian people is a global case in reference! For instance, during the Second World War manyeconomies had tax exemptions on their middle-income groups and instead, capital levy on the richest people was imposed to fund the exigencies of war.

All the above stated factors have to be considered by the policy makers while taxing the people of an economy. People of an economy also have to keep these factors in mind to decide if they want and have the capacity to pay the taxes imposed by their policy makers. Otherwise taxable capacity is not at its best. However, it is often said that "you cannot tax the people and at the same time please all the people. It is also observed that countries evolve better tax system to derive higher taxable capacity over the years of policy making experience. It is in this context, we can conclude with the statement of Findley Shirras "A road leading to an important center has often many crossings, sign posts, danger signals, but it does not lessen its value to the cautious sojourner."

Importance of Taxable Capacity

Figure 2.5 Importance of Taxable Capacity

This concept is not accurate for measurement purposes. But still, it is well recognized by both policy makers and individuals and corporate because of the following reasons:

a. The concept gives a summary view of the maximum funds which could be collected from the people in case of unexpected national emergencies like war, climatic havocs and massive health exigencies. During all foreign rule in India and around the globe, there are clear country cases such as Scandinavian economies whereawareness of taxable capacity among the people has led to optimum of tax compliance by tax payers.
b. The concept gives potential source of funds in the form of taxes to embark on future long-term development goal, for economic development and planning.
c. Understandingtaxable capacity creates vigilance among policy makers against imposing exorbitant taxes beyond the bearable limits of the people of the economy.

d. This concept can help federal union Government like in India to compare the taxable capacity of the states before imposing federal taxes.
e. During devolution of funds from union Government to the states, refers to distribution of resources from Centre to the states with different taxable capacity, knowing the concept enables balanced and fair distribution of resources to the people of the states.

To Do Activity: Students can be asked to collect short stories about taxes without considering taxable capacity.

Teachers can show evidences in history where kings got appreciation for considering taxable capacity during tax collection

Estimation of Taxable Capacity

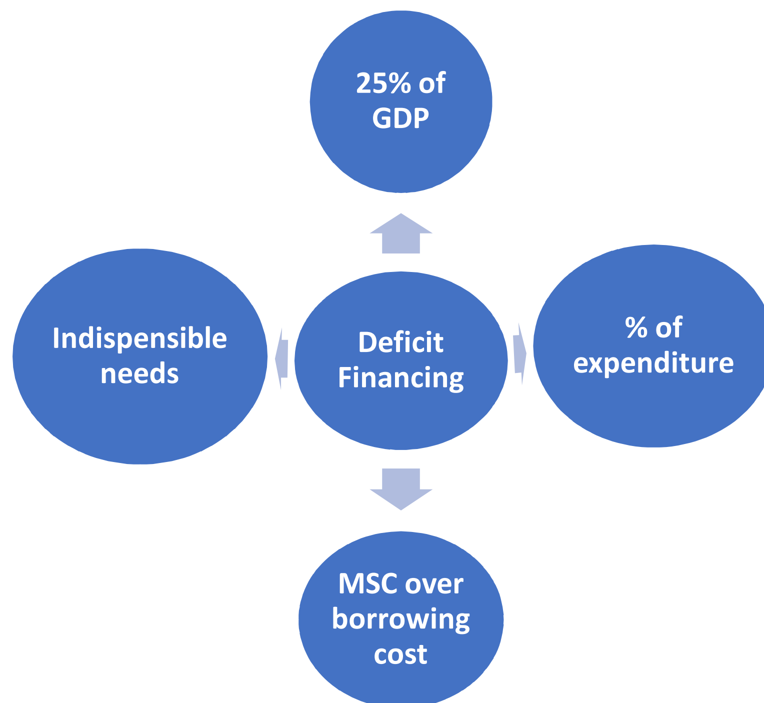

Figure 2.6 Estimation of Taxable Capacity

Many economists have tried to find out how much the general taxable capacity of a country is? Colin Clarke states that for most of the economies of the globe, taxable capacity is 25% of the national income. It is the safe upper limit of taxation. If it is exceeded, there will be adverse effects on the willingness to work because they will feel that a greater proportion of their income will go out of their pocket as tax. Higher level of tax is also inflationary. Inflationary rise in prices will leave less in the pockets of the people to save. This also results in low investment. So, they will be discouraged to work, save and invest. Critics of Colin Clarke point out that taxable capacity at 25% of GDP is true of developed countries and not less developed economies. They also refute Colin Clarke saying that safe limit of

taxation in one country may not be the safe for another economy. Safe limit of taxation for an economy at one time may not be the safe limit at another time point.

Nicolas Kaldor advocates measuring taxable capacity in terms of expenditure of individuals and not income. Taxing income has negative impact on savings and investment according to him. Simon Kuznets looks at taxable capacity in terms of public expenditure in proportion of national income needed for the satisfaction of indispensable needs of people exclusive of those rendered by the Government. Amotoz Morag advises that taxable capacity should be measured at that point where marginal social cost of additional taxation exceeds cost of resorting to borrowing from banks.
Following diagram explains this estimation:

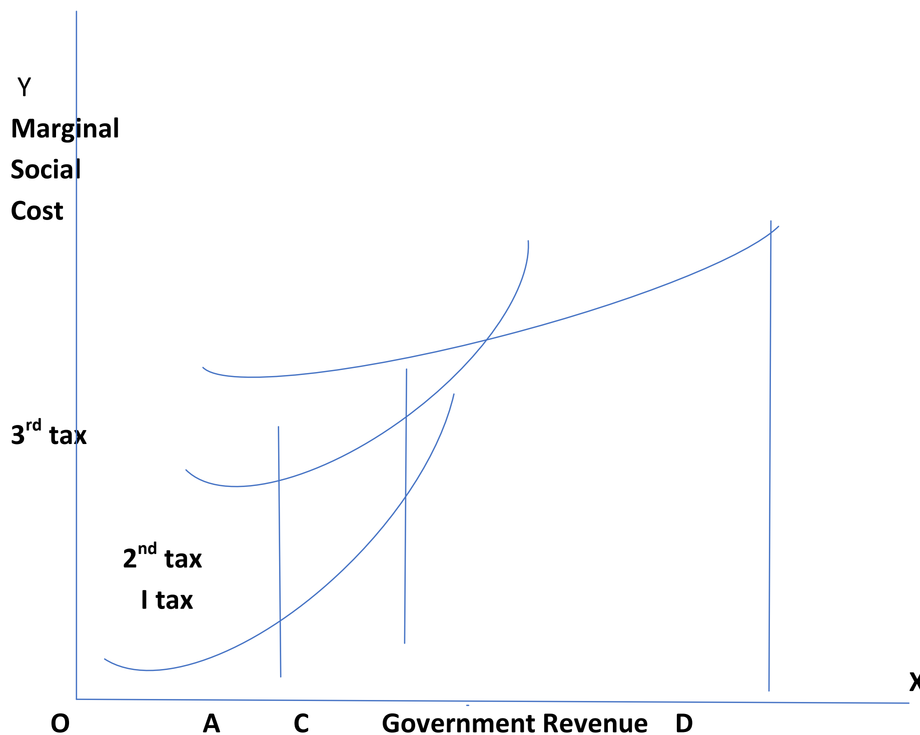

Figure 2.7 Amatoz Morag Estimation of Taxable Capacity

In the above figure OX horizontal axis indicates Government revenue (refer I Chapter) is shown and vertical axis OY shows marginal social cost. Marginal social cost is the additional cost that society has to bear to pay tax. In this situation marginal revenue only from the considered alone is changing and revenue from other sources is remaining constant. First tax derives a revenue of OA, second tax mobilizes the quantity of revenue AC and third tax CD. When the marginal social cost of first tax is more than S limit of taxable capacity for the first tax, second tax is introduced.

When the limit of taxable capacity for the second is reached at R the third tax is introduced. So, when the total tax revenue is T= OA+AC+CD, deficit financing is resorted to. But no concrete taxable capacity can be given. This approach tells us that taxable capacity is estimated with marginal social cost.

It is clear that taxation is implemented and distributed among individuals and groups not only considering the principles of taxation, but as a matter of political and economic environment. Taxable capacity which is defined as least aggregate sacrifice is not complete without practical considerations. Thus, we can see that any estimation of taxable capacity has to be applied as per suitable situations.

Absolute taxable capacity can be measured as a maximum amount that can be collected compulsorily without negative effects, from the people or community. Tax payers would have to have sufficient funds to meet their needs of consumer goods and services, to prevent serious discontent which tends to reduce efficiency and investment. The residual funds will be made available for public expenditure through tax. These funds indicate taxable capacity. It can be estimated as follows:

If $\mathbf{y_t}$shows real income, $\mathbf{E_{mt}}$ is minimum consumption expenditure, and **T** is absolute taxable capacity
Then $\mathbf{T = y_t - E_{mt}}$

In rural India, income is fluctuating with monsoons and change in weather conditions. Funds available for consumption expenditure are inadequate. This is due to fluctuating and low real income. Real income is the amount of goods and services one can by with the income or purchasing power of income. Therefore, agricultural income is exempt from taxation. So taxable capacity of rural India is low. Most of the population depends on agriculture and allied sectors (animal husbandry, fisheries, Bee keeping etc.). To increase rural taxable capacity economic reforms have introduced commercial farming, modern methods of marketing, organic farming, medicinal farming etc.

The choice of estimation of taxable capacity has to be determined on the basis of conditions of a particular economy.

To Do Activity: Students can be asked to debate which estimation is better

Impact and Incidence of Taxation

The study of impact and incidence is an important domain in public finance. Taxes are classified on the basis of this differentiation.When the procedure of taxation is considered, compulsory burden is imposed on the person who has to pay it. It is interesting to observe who bears this burden!

On the basis of this research, it is found that when an entity is taxed (person or group of persons/ household or a firm), the first entity on whom tax is imposed is supposed to be bearing the impact. In other words, first burden of tax is called impact. The final burden which cannot be transferred any further, is called incidence.

It is not essential that this impact bearer should ultimately pay the tax. If the impact (first burden) bearer transfers the tax burden to another entity which actually pays the tax, the final burden is borne by the actual tax payer. Incidence of tax falls on those who cannot transfer the tax burden to any other entity. In case of such taxes, impact bearer transfers the incidence to another entity are often called indirect taxes. In case of these taxes like commodity taxes like GST, impact is on the producer. But the incidence is on the consumer. Tax element is hidden in the price component and consumer bears the incidence.

In the process of taxation, all entities desire to save their money by saving actual tax payment. But the actual tax payer is he, who cannot shift his tax burden to any other entity. The final burden is termed as incidence of taxation. For example, income tax/Corporation tax are imposed on individuals/companies who/which are beyond an income limit. The entity on which impact falls is also the entity on which incidence falls. Such taxes where impact and incidence are borne by the same entity are called direct taxes.

Meaning of Incidence of Taxation: it is the concept showing the actual money burden of taxation. It could be said that incidence shows who pays the direct money burden of taxation. Findley Shirrassays "the problem of incidence is the analysis to determine who pays the tax i.e., on whom the money burden of tax falls or rests".

To Dalton "it is commonly conceived as the problem of who pays it". Richard Musgrave states that" the concept of incidence is the location of ultimate burden of a tax which starts rom the false premise that a tax as such has an ultimate burden"

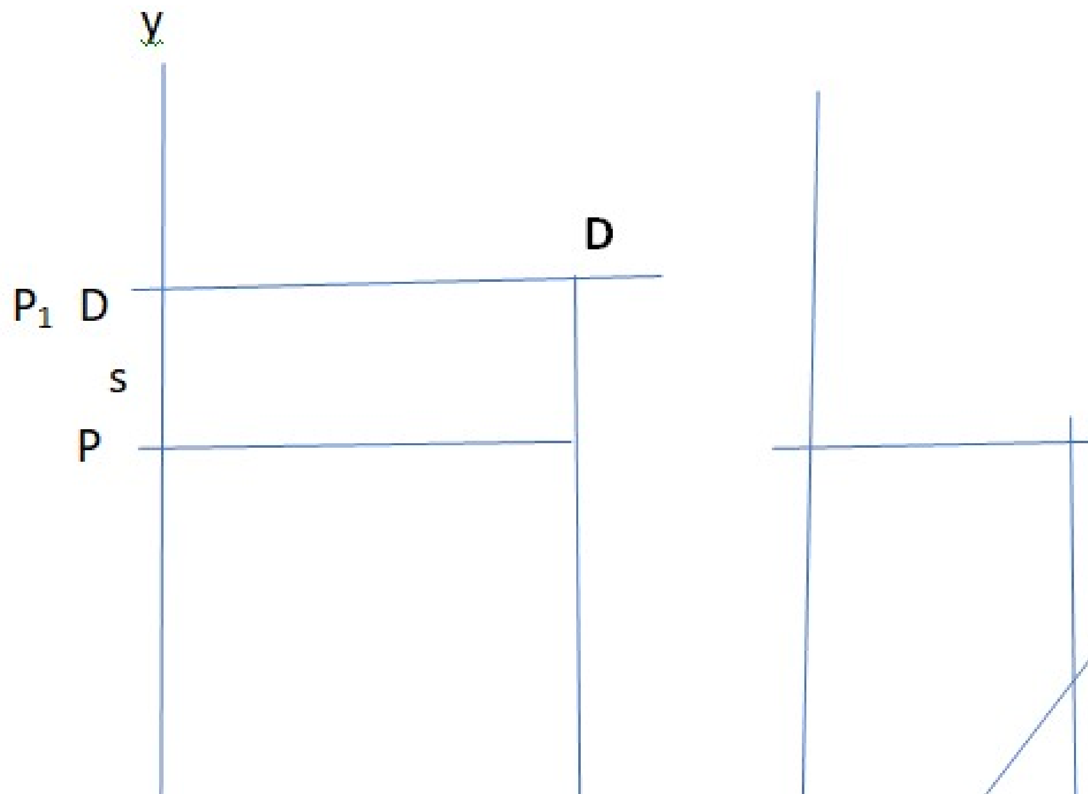

Figure 2.8 Shifting Indirect Tax Incidence

In the above figures x axis shows quantity and y axis shows price. Vertical line DD in the First figure shows constant demand. With oq indicating quantity supplied for all points of demand also remaining constant. If there is tax taxation this situation, price rises from OP to OP_1.So, incidence of this commodity taxation is on consumers. If there is tax is imposed when demand is constant at DD and price also remains constant at OP, then quantity supplied will be decreased by the producer. So even in this situation incidence of commodity tax is on the consumer but through quantity change. This is one case where price elasticity of demand is 0(or inelastic demand.

To Do Activity: Students can be asked to draw graphs with changes in price, demand and supply to understand what happens to incidence of commodity taxes.

Tax is a compulsory payment imposed on all inhabitants of an economy. As it reduces his ability to consume, it is always undesirable to bear the incidence of taxation. So, the impact bearer of a tax tries to transfer the burden of taxation on some individual or entity either through backward or forward transfer of incidence. He tries to transfer either the complete burden or at least partial burden of taxation. It is observed that there is forward shifting and backward shifting of taxes.

The incidence bearer pays the tax because he cannot transfer it to any other entity. That is to say that all shifting of tax burden are completed before incidence of taxation is determined.The process of transfer of tax burden is called ‘shifting’ in tax parlance. It is always undesirable to pay taxes as it takes off money

from the pockets of the people.it reduces the purchasing power and affects the economic life of the tax payer. So, to save depletion of his income, by paying tax, he places the incidence on another entity.

Factors influencing the Shifting of Tax Burden

The degree or extent to which tax can be shifted depends on the following factors:

a) Elasticity of Demand: If demand for a product is constant, shifting of tax burden is facilitated. The producer can vary the prices or his supply and its quality as per his needs since demand will not change consequently.
b) Supply or cost conditions: Demand remaining constant, if supply is elastic also, it facilitates producer to vary supply and price.
c) Nature of the market: In a monopoly both supply and price can vary as per the needs of the seller. Price tends to be highest with the tax component shifted and supply will be reduced to the extent seller desires. In imperfectly competitive market, change in price as well as quantity and price of a commodity depend on elasticities of demand and supply for the product and product differentiation. Therefore, the price is indeterminate. However, it is lower in the short run and higher but lower than monopoly in the long run. Price rises least and there is supply variation to the least extent in a perfectly competitive market in the short run. In the long run, tax is borne by the producer and there is no shifting of tax burden due to perfect competition. Equilibrium price is restored in the long run.

Types of Shifting

Shifting of tax burden could be to a single point that pays the tax or multiple points that finally pay the tax. If/when the producer shifts the burden of tax of his product on the consumer by including it in price. In this situation, price is higher than it would be without tax. But through price, consumers actually pay it automatically when they buy the product, it is single -point shifting. For instance,when the farmer sells his produce to the wholesaler, and the wholesaler shifts the whole burden to the retailer. Retailer shits the whole burden to the consumers who pay it through price.

If the single tax impact bearer shifts its incidence to many points of incidence, it is termed as multipoint shifting. If the same farmer processes his produce, standardizes and packages them to add value to sell to consumers, he can shift his tax burden to processing unit, packaging unit and to the consumer. This is a case of multipoint tax shifting.

Processes of Tax Shifting

Shifting of tax incidence happens normally through the following processes:

Shifting of Tax through Price

Producer usually increases the price of the product to include the tax element and his desired profit. Tax is at least partially shifted to the consumer through price. Such shifting processes can happen only in case of price transactions. In market economy price is the only vehicle of tax reimbursement. By price it

is meant price of all goods and services. Prices in market economy includes payment to all factors of production. Thus, price alters to include tax element. This change in price is achieved through essential quality and quantity alterations. Prices could be the same with reduced quality or quantity. Here there is shifting of real burden of tax. Otherwise prices could be increased for the same quality. This is a case of shifting of money burden of tax. There are efforts sometimes to expose the hidden shifting of burden if the taxes can be shifted. This is to create consciousness among consumers about their tax contribution to the Government.

Forward and Backward Shifting of Tax

Shifting often happens through manipulation of price of a commodity that is taxed. The producer could also reduce the quantity, keeping the price of his product constant. He can even reduce the quality of the product while retaining the price. These efforts are to pay the tax and shift its burden to the consumers at least partially.

Forward shifting is the most common form of shifting of tax incidence. Producer may shift the tax burden as stated above, to the wholesaler. He (wholesaler) might further shift the tax burden on retailers by manipulating prices of the product. Finally, the retailer increases the price and the incidence of taxation is shifted to the consumers. Normally, the entire burden of tax is shifted in such cases to the consumers. The product quality and quantity are drastically reduced or price happens to be abnormally high by the time the product reaches consumers, due to forward shifting of taxes. Best cases in this context are agricultural produce. The price of an alphonso mango is $5/head in USA and its quality is far lower than the same mango from a Chennai grocery. This is due to transport cost and tax component being added.

Backward shifting happens when tax burden is shifted into the process of production, on the agents of production. In India it is common for wholesale sellers to persuade farmers to sell at lower prices due to tax imposed on them. Farmers may in turn ask laborers to work for lower wages to share the tax burden. Farmers may ask the land owner to reduce rent on cultivated land to pay tax. These shifts will enable farmers to make good profits in spite of tax as the tax burden is shifted through their backward linkages.

To Do Activity: Students may be asked to find the price of some village products and find their price at the point of production and in the urban market and malls.Price components may be discussed in the classto separate out components of cost of production and GST.

Tax Capitalization for Shifting of Incidence

This shifting is a unique case of backward shifting. Durable goods like inventories and capital goods are taxed many times in their life span. They are subject to successive annual taxes throughout their life time. So, if the whole series of taxes are to be shifted backwards at the time of purchase of a capital good, the future taxes must be capitalized and deducted as one sum from the offer price of the capital

good. This is termed as capitalization; the shifting partially or wholly done owing to the conditions of sale. For example, when a house has to be purchased, the buyer may estimate the taxes he would have to pay on the house annually and ask for reduction of that lump sum from the price of the house. The price of the house may have to be sufficiently reduced to meet future taxes for a specific number of years to be stated during the purchase. Otherwise, the remaining amount of tax burden will be borne by the buyer. This is complete or partial shifting of tax incidence through capitalization.

Effects of Taxation

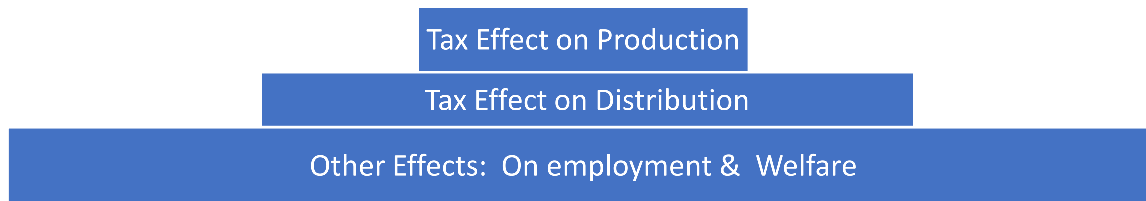

Figure 2.9 Effects of Taxation

Tax is a financial burden on the consumers and producers. It reduces the money in their pockets. So, it has effects on the entire economy, economic growth and development. Policy makers and people have to mind the effects of taxation on the following aspects. Otherwise there will be undue effects on the economic aspects. Most important effects could be traced as follows. Following are the most important effects of taxation:

1. Effects of Taxation on Production and Growth

Taxation affects the ability of people to work. This is because greater commodity taxes are a disincentive as the real income declines. This means they have to pay more out of their pockets as GST is added to price and so price rises. If very low direct taxes encourage higher profit margin for producers and encourage investment which is followed by employment generation, such tax is justifiable. But if low direct taxes like income tax and property taxes increase revenue of rich people and employment is not increased while capital stock (machines and money) increases, such tax is not justified. This encourages ability to pay of people. This leads to higher production and higher demand for goods and services. So national income rises year after year. This is termed as economic growth and thus economic growth rises.

Higher taxation discourages production and lower taxes encourage production. So, the pattern of production could be determined through taxes. Using this weapon, Agriculture is left untaxed. Rural artisans are taxed low and rural SMEs also are taxed low. This is to encourage more investment and production in agriculture, rural artisans and SMEs. This policy is bearing results through direction of

production pattern. Indian agricultural productivity has increased multifold after independence till date. We now are placed in a situation of 2nd green revolution where sustainable agriculture is the centrifuge and not only productivity. A portion of credit for this goes to tax policy of last 70 years in post independent India.

To Do Activity: Students and faculty members could go to rural areas and interview farmers about how much of all taxes they pay and how much taxes their previous generation paid.

2. Effects of Taxation on Distribution

Different taxes have different specific effects on distribution. Generally, lower direct taxes lead to more investible funds and lead to higher profits, other things remaining constant. Higher profits when reinvested are distributed as income of factors of production. Higher taxes on undesirable sectors will not distribute income to the factors of production that flow from those sectors. So also, higher commodity taxes on undesirable commodities, harmful goods and non- essential goods will deter demand and so consumption of those goods. Investment for those goods declines as a result. Thus, taxation can control, direct and monitor distribution of income towards desired goals. For instance, cigarettes are taxed more than 100% of cost of their production as they are harmful for health.

3**. Miscellaneous Effects of Taxation**

There are indirect effects(outcome) of taxation such as the following:

a) **Employment Effect of Taxation:** Some Economists argue that higher taxation reduces funds available for investment and consumption. So, it reduces investment leading to reduced employment. However, this argument is countered by the fact that the funds collected through tax are allotted for public expenditure used for employment creation. So, to what extent the fall in employment due to higher taxation is countered by public expenditure on employment schemes will have to be estimated for accurate statement about effect of taxation on employment. Tax compliance is high if higher direct taxes are spent through public expenditure on employment generation.

b) **Welfare Effect of Taxation**: Tax revenue enhances welfare of the concerned people when the tax proceeds are used through public expenditure to improve the life of the people. In other words, if the Government uses tax revenue to increase social infrastructure like health and education and physical infrastructure in the form of transport, communication and Information technology, welfare effect is positive. People are willing to pay taxes if this happens. If tax revenue is spent for administrative expenditure to increase the size of the ministry, number of civil servants and infrastructure for the Government's administrative use, foreign tours by ministry and bureaucrats, if tax revenue leaks out for personal use of ministers and bureaucrats, inflating defense administrative expenditure and for avoidable use of police force and security infrastructure, welfare of the people is given lower priority.

For example, if tax funds are allotted for loan waiver of farmers, welfare of farmers increases. Productivity of farmers will increase in the long run. Welfare measures like minimum wages, MGNREGS and UBI are said to please tax payers less than development expenditure that creates employment directly. But welfare schemes please tax payers unlike rise in administrative expenditure and defense expenditure which displease them. This is because these measures execute equitable redistribute income and wealth in the economy. They also lead to long run development. But the extent of development promoted cannot be measured accurately. Scandinavian economies are tax compliant because of cradle to grave welfare provisions. For instance, Norway not only funds foreign education of students but also gives them connected career options on their return to home country.

To Do Activity

Students could be taken to meet Government bureaucrats and ministers to interact with them about how they spend tax money.

Students can meet tax officials and find out how they consider taxable capacity and its effects while taxing people.

During annual budget teachers can show the news coverage or allow them to watch budget presentation to observe tax revenue collected and allotment of funds for various purposes through public expenditure. Students could be asked how far welfare is promoted.

In brief, whether taxation has favourable effects or unfavourable effects on the people depends on how the tax funds are channelized through public expenditure for various objectives related to the welfare of people and development of the economy concerned. Both policy makers and tax payers have to be mindful of the above said effects and understand related further details to meet the aims and objectives of a globalized welfare economy.

Taxation and Public Expenditure

Economic Policy is the policy of the government about economic aspects of the country. It consists of monetary policy and fiscal policy. Fiscal policy is a part of economic policy consisting of public revenue and public expenditure. Public revenue being secured to the largest proportion in the form of taxation, taxation and public expenditure are two weapons of fiscal policy. They are like two sides of the same coin of fiscal policy. Taxation is implemented in the form of direct and indirect taxes.

After independence, both tax revenue and public expenditure show increasing trend. But public expenditure has increased more than tax revenue. This increased expenditure is met with deficit financing and public debt.

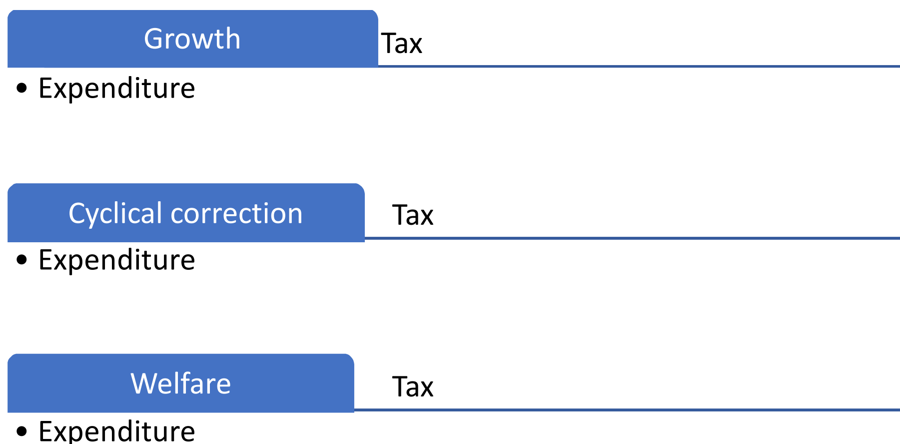

Figure 2.10 Tax-Public Expenditure Relationships

To Do Activity: Students can act as Finance minister and interact with their class, about how they would change taxes for growth, welfare and cyclical correction

The revenue collected in the form of taxation is prioritized and used for various forms of public expenditure according to the aims and objectives of the economy. In developed economies tax collection is high. But the funds collected through taxation n developed economies are channelized effectively though developmental expenditure and welfare expenditure. Such a functioning of public expenditure gives credibility to taxation and encourages tax compliance. In less developed economies, leaking of funds out of public expenditure is a major issue. Accountability in public expenditure is yet to be perfected. This leads to people's desire to avoid and escape taxation. Public expenditure is in the form of expenditure on defense expenditure, Administrative expenditure, developmental expenditure and welfare expenditure. The relationship between the two concepts is seen during the drafting of economic survey released the day before the announcement of Budget. Budgetary allotment for economic growth, economic stability and in welfare programs reveals public expenditure.

Relationship during Economic Growth

Rise in tax revenue is expected to be followed by rise in public expenditure. In a developing economy economic growth takes the leading priority. Therefore, tax revenue is spent on measures to increase the speed of economic growth through direct funding for income generating projects. Here those sectors which generate more growth or those that generate ling term growth with a single lump sum investment or periodical investment by the Government such as public expenditure on initiating large scale industries, Strategic industries, Agriculture, physical and social infrastructure and communication. This is in order to spur increase economic growth and its speed. Through expenditure on economic growth, employment is generated for further growth. Indian Government's initial revenue was spent on starting iron and steel industries with foreign collaboration, locomotive industry, Air craft producing

industry, telecom, fertilizer industry, multi- purpose irrigation projects. These Government ventures at the dawn of independence are generating sustainable employment and income which have promoted economic growth of India after independence.

Relationship during Economic Instability

Tax collection and public expenditure are used as major fiscal weapons during economic instabilities. Duringinflation, tax rates are increased and new taxes are levied to cut the funds available as profits among investors. GST is increased and supply is maintained constant with state monitoring, so that the price rise stabilizes. During Indian economic reforms of 1991, double digit inflation was brought under control with discretionary taxation, introduction of new taxes and state monitoring of supply and demand. This is called contractionary fiscal policy. At the same time, public expenditure on inflationary sectors is cut so as the produce goods and services to stabilize price rise. At the same time to encourage correction of cyclical instability. During recession, Government intervenes to reduce taxation on investment and commodities so that sluggish economic activities increase. It is expected that investment rises with lower taxation.

Public expenditure to give purchasing power in the hands of people as subsidies and rationing is increased. Administrative expenditure is also enhanced to give money to spend in the hands of people. Infrastructure investment by Government to provide employment is increased to spur up demand for goods. This is called pump priming policy.

At present India is facing the challenge of recession. Experts have diagnosed the causes of present recession are Changes in the objectives of governance, Climate change, laxity of demand, global changes in technology. Pump priming which means pumping of money to the consumers through public expenditure. This is because theoretically it is established that lower income groups have MPC>1. MPC of middle-income groups have MPC=1 (MPC is marginal propensity to consume) and highest income groups have MPC<1. This is most popularly used as a fiscal policy to activate demand side. Towards this central government is can initiate long term and heavy budget physical infrastructure building. China is supposed to have taken gigantic infrastructure works to tackle recession. Non -resident Indian (NRI) investment could be sought by both union Government and the states to deal with recession. The Government can appeal to their patriotism, provide tax incentives and level playing field to attract NRI investment. Present Central Government's reduction of corporate tax is a historic step in Indian tax history to spur investment towards recession control.

The Relationship in Welfare Programs

Majority of the economies of the world are having welfare as their aim. In welfare economies, Public expenditure is used as the channel through which subsidies are given to the lowest income group to tackle and come out of poverty. Private sector and individual philanthropists supporting such programs are given tax incentives. In addition, accumulation of wealth and income and monopoly over large investments are controlled through taxes and restrictions on them. Tax rate on highest income bracket is the highest in most of the countries of the world and often considered to be regressive as it

discourages investors. The funds mobilized through taxation funds public expenditure on welfare provisions. For instance, in India we have employment guarantee program like MGNREGS (mahatma Gandhi National Rural Employment Guarantee Scheme), minimum nutrition program for mother and child, now we are discussing UBI (Universal Basic Income) which several developed economies are focusing on, through public expenditure. UBI means giving an amount as an annuity or as a monthly payment into the individual bank accounts, which caters to the minimum needs, to all the inhabitants of the country. In Scandinavian economies, New Zealand and Canada cradle to grave services are given by the government to deal with uncertainties in life like education, job, child birth, health and aging.

To Do Activity

The class could discuss welfare programs in India which they have understanding about.Health programs of present Government could be watched on connected ministry's website

2.4 Corporate Social Responsibility (CSR) and Taxation:

Figure 2.11 CSR'Beyond Taxation'

Investors automatically distribute income to individuals through employment for services in the process of production. But this income is evidenced to be inequitable. Profit considerations do not allow forcing private investors to distribute income in an equitable way. So, Government intervenes to redistribute income and wealth by creating physical and social infrastructure for all people and by spending on special provisions for minimum nutrition, health, training and education of the poorest people so as the enable poor to deal with poverty and effectively come move out of poverty through education and training to get jobs that ameliorate. High taxation on the rich in the form of individual income tax, corporate taxes like capital gains tax and corporation tax, wealth tax, gift tax, minimum alternative tax take away the excess income and wealth from the richest. Corporate retained earnings are also high. It is observed that corporate profits and assets are leading source of concentration of wealth. To mop up this accumulated source of income and wealth, 'Corporate Social Responsibility' (CSR) is imposed by the Government on the corporate. As per 'Companies Act of Corporate Social Responsibility 'it is mandatory for listed Companies to allot 2% of their annual revenue for CSR spend.

Modern Governments are also finding it hard to afford adequate amounts for innovation, welfare expenditure and climate change issues amidst growing needs of developmental expenditure. This also rests on the premise that corporate honchos can spend beyond expectations and business, breaking barriers to facilitate innovation, inclusive growth and wellbeing of all in India. All listed companies are required to spend at least 2% of their profits on social sector. The way in which this fund is spent is left to the discretion of the concerned company but transparent proposal and report of the activity with budgetary allocation and the agent which implements the CSR project has to be submitted to the Government Aditya Birla Group, WIPRO, Reliance, Infosys.

To Do Activity

Students can be asked to find out from friends and relatives about the CSR activities they have come across.

Students can be taken to visit CSR project sites of sample companies.

Faculty members can visit CSR wing of sample Companies

CSR Heads of some sample companies could be invited to give a summary view of their activities

Model Questions

1. Define taxable capacity
2. Differentiate between absolute taxable capacity and relative taxable capacity giving examples
3.Explain the importance of the concept of taxable capacity
4. Discuss the factors influencing taxable capacity
5. Can taxable capacity be measured accurately? Discuss
7. What is impact of taxation?
6. Define incidence of taxation
7. Who bears the incidence of direct taxes?
8. On whom does the incidence of indirect taxes fall? Explain
9. Discuss how incidence of commodity tax changes price and quantity of the concerned product with a diagram.
10. What is the meaning of shifting in tax parlance?
11. What are the factors influencing shifting?
12. State the types of shifting taxes
13. What is tax capitalization for shifting of taxes explain?
14. Discuss the process of shifting of incidence of taxation
15. Examine the effects of taxation on production and distribution in an economy
16. Discuss the effects of taxation on the following aspects:
    a) Ability to work and invest
    b) Direct effects on will to work
    c) Allocation of resources
17.Explain how taxation and public expenditure can go hand in hand to fiscal policy

18. Explain contra- cyclical taxation and public expenditure policies that go together

19. Explain how CSR enhances social sector beyond redistribution by the Government with a case study

20. Define CSR.

21. State the need for CSR

22. Give the case of a CSR activity of any one Indian Company

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Chapter 3 Types of Taxes

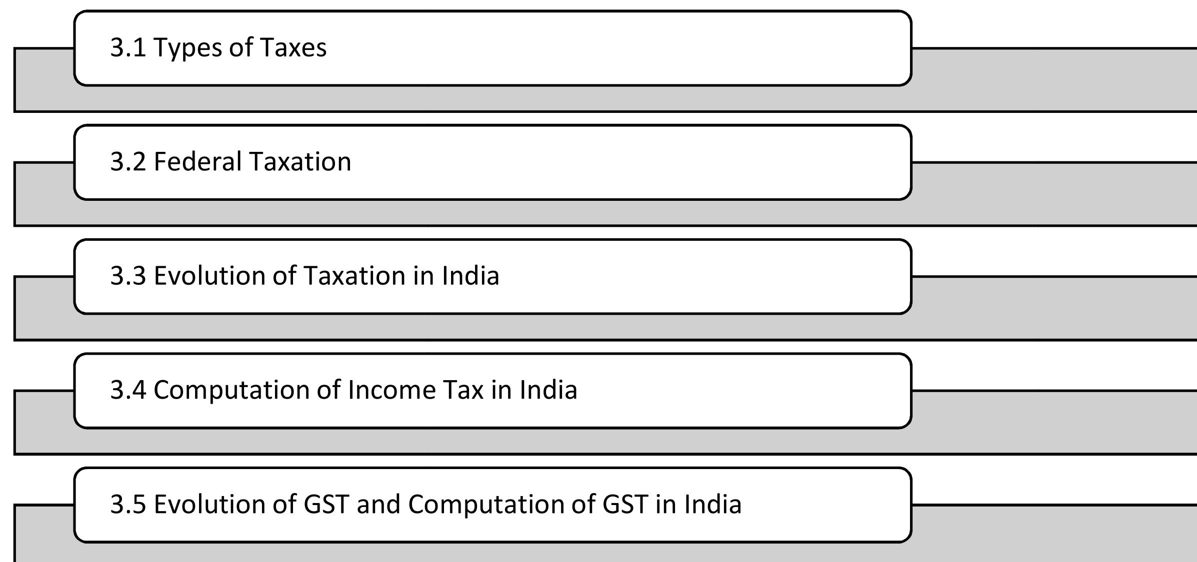
Introduction

To become adept policy makers or to administer the taxes on the people or even to be a compliant tax payer, we need to know the internal structure of taxation. In this direction, it is interesting to know the different types of taxes that unfold to us, the differences in the nature and mode of implementation of taxes which this chapter provides. The effects of taxation change the life of the people and way the economy develops. Therefore, policy maker has to be mindful of effects of taxation before imposing each type of tax and in the proportion, it is imposed. So also, these effects have to be thought out by people to optimize their well-being. Concepts of public expenditure and Corporate Social Responsibility have to be cohesively related to taxation. This chapter endeavors towards these aspects.

Objectives

- To provide insights on nature and types of taxes.
- To familiarize federal taxation
- To explain evolution of taxation in India
- To enable them to compute income tax calculating exemptions, deductions and age based tax rates in year on year (YOY) budget.
- To provide insights on how to save tax and which sections can save more tax.

Chapter Structure



Classification of Taxation

Taxes are classified on the basis of form, nature, aim and methods of taxation. Following classifications are commonly found in the modern tax system:

- Direct and Indirect Taxes
- Specific and Ad Valorem Duties
- Progressive, Proportional, Regressive and Digressive Taxes.

A modern tax system is generally composed of these kinds of taxes. Moreover, one classification does not contradict the other, but complements each other.

3.1Types of Taxes

Direct and Indirect Taxes

Comparison between Direct and Indirect Taxes

As direct and indirect taxes are the most popular classification, they are often compared.One view is that an indirect tax is one which can be shifted or passed on, a direct tax is one which cannot be shifted or passed on. It means that in case of direct taxes the impact or immediate monetary burden is on the one and the same entity, while that in case of indirect taxes, the impact and incidence of tax are on different entities. Hence, income and property taxes can be called as direct taxes, while custom and excise duties are indirect taxes. Though this is commonly an accepted distinction between direct and indirect taxes, it may not always be possible to trace the incidence of any tax exactly. For instance, it is difficult to find out that a tax on the production of vanity bags has been shifted to the consumers or not. Thus, the same tax may sometimes be direct and sometimes indirect.

Another difference is that the government intends that a person, who legally pays the tax, must bear its burden; it is a direct tax. But if the government contrives in such a way that a tax collected from one should be transferred to others, it can be termed as an indirect tax. Here, the basis of comparison is policy makers’ intention behind the levy of a tax. However, the intention of the policy makers may not always materialize. The government may intend that a tax should be shifted to the consumers, but such shifting may not actually happen.

Another comparison is that, the difference between direct and indirect taxes is based on the immediate and not on the final incidence. Taxes, which are legally shifted and those which are not shifted at all, are direct; but those, which are shifted through commercial competition between producers and consumers, is an indirect tax. It is also felt that those taxes levied on long run and repeated occasions are direct, but those levied on occasionally and specific events are indirect. Fong by this comparison, death duties considered as direct taxes (no more exist), would be indirect taxes.

Sometimes, it is said that if the income of an entity is assessed directly, it is a direct tax. If an income assessed indirectly during its spending, is an indirect tax. However, both income and expenditure are complimentary.Another point of comparison is that if taxes are imposed immediately on income and

property and those paid by consumers directly to the Government are termed as direct taxes. Examples are income tax, wealth tax and corporation tax. But those taxes which influence income and property of individuals through their consumption are termed indirect taxes. This difference is often recognized by academia and policy makers. The above distinctions between direct and indirect taxes are subtle and are realized over usage by consumers and policy makers

Merits of Direct Taxes

Direct and indirect taxes form essential counter parts of tax systems of economies of the globe. Each has the following merits and demerits

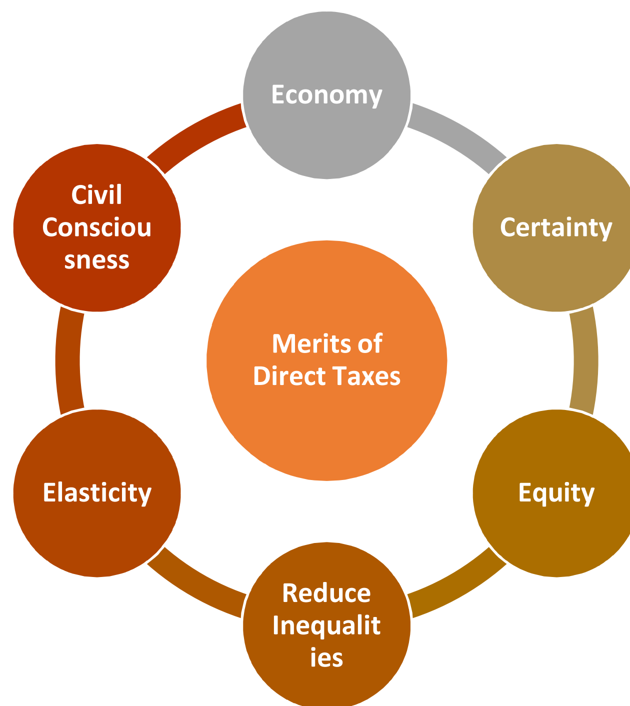


Figure 3.1 Merits of Direct Taxes

Economy – The administrative cost of collecting these taxes is low, because the same officers who assess small income or properties can assess larger incomes and properties. Furthermore, the taxpayers pay these taxes directly to the state. So, all money taken out of the pockets of the taxpayers is deposited into the state's treasury. Now online remittance of direct taxes has also made the tax economical.

Certainty – These taxes also in accordance with the canon of certainty. The taxpayer knows for certain about the amount he is expected to pay. Similarly, the state knows for certain, the amount it has to receive as direct tax revenue.

Equity – Direct taxes are lauded to be fair and equitable as the basis of the tax is the principle of progressive taxation. Therefore, their burden falls more on the haves and not the have nots.

Reduce Inequalities – As direct taxes are progressive in nature, and so the rich are levied with higher rates of taxation, while poor people are exempt from direct tax payment. Hence, these taxes act as an instrument to decrease inequalities in income.

Elasticity – The taxes also elastic, as the government revenue may be increased just by increasing the rates of taxation. In addition, the income from direct taxes also increases with the increase in income of the people.

Civic Consciousness – The payers of direct taxes are aware of the tax rates, trends and how the money they paid to the Government is spent through public expenditure. Thus, direct taxes create civic consciousness among the taxpayers. As the tax-payer may take rational and keen interest in the way in which public expenditure is incurred, whether the revenue raised is properly utilized or not. In a democratic economy, such civic consciousness arrests wastages in the public expenditure.

Demerits of Direct Taxes

Government tries to keep direct taxes as far as possible in such a way as not to impose over dose of direct taxes.This is due to the following demerits:

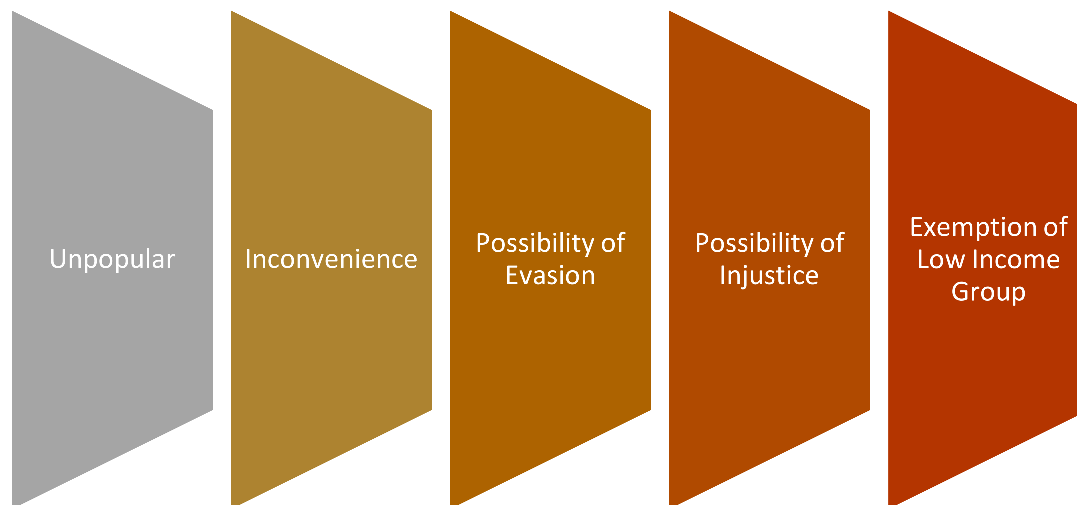


Figure 3.2 Demerits of Direct Taxes

- **Unpopular** – The direct taxes are generally not shifted, and therefore they are painful to the taxpayer. Hence, such taxes are unpopular in nature, and are generally opposed by the taxpayers.
- **Inconvenience** – These taxes are also inconvenient in nature, because taxpayer has to submit the statement of his total income along with the source of income from which it is derived, which is generally subject to complications. Moreover, the payment of these taxes in lump sum is not as convenient to the taxpayer as the frequent payment of small amounts of indirect taxes. Hence, these taxes are inconvenient to the taxpayers.

- **Possibility of Evasion** – A direct tax is said to be a tax on honesty, it is not evaded only when the taxpayer is honest, otherwise, it can be evaded through fraudulent practices. Hence, it is found that it can wholly or partly be evaded, if the taxpayer decides to become dishonest.
- **Possibility of injustice** – In practice it is difficult to assess the income of all classes accurately. Hence, the direct taxes may not fall with equal weight on all classes. Moreover, the rates of direct taxes are arbitrarily fixed by the government, and they may not be on the basis of ability to pay.
- **Exemption of low-income group** – If only direct taxation is resorted, the low-income group people cannot be approached by direct taxes, as they are normally exempted from such taxes on the basis of ability or equity.

However, direct taxes are advantageous and these objections to them arise out of administrative procedure rather than on grounds of fundamental principle. These objections can be gradually removed with experience.

Indirect taxes are those in case of which impact of taxation is on one entity and incidence of taxation is on another entity. The tax is imposed on producers. Impact of an indirect tax is on the producer. But the producer shifts the burden of tax to the consumer. Consumer bears the final burden of tax included in price

Merits of Indirect Taxes

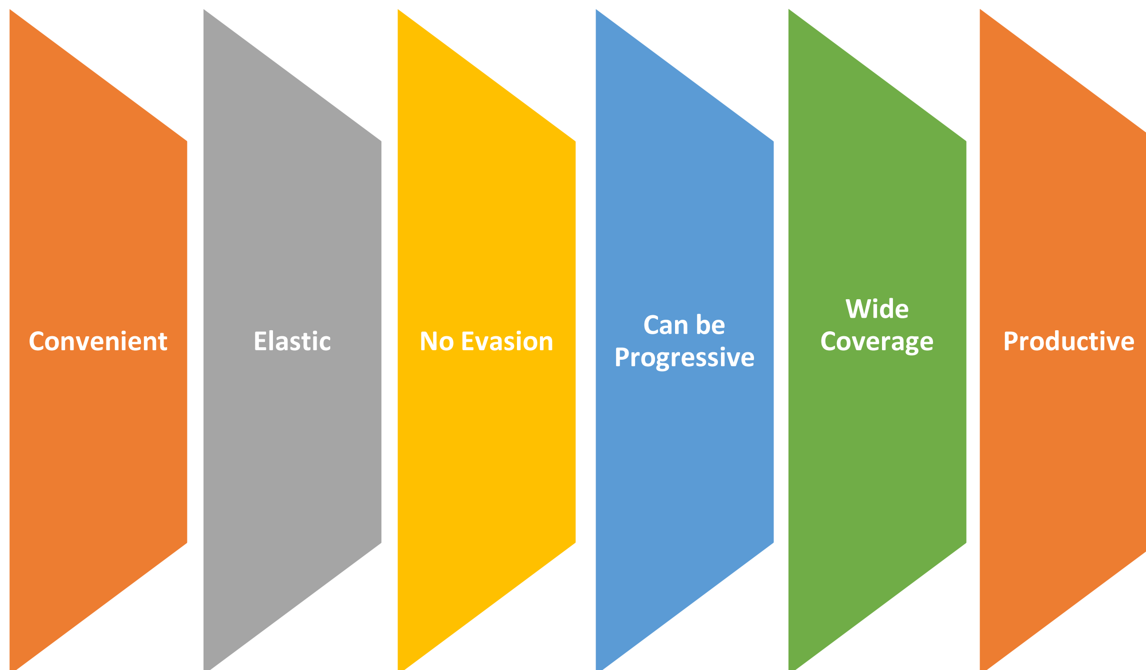


Figure 3.3: Merits of Indirect Taxes

- **Convenient** – Indirect taxes have the merits of being convenient. They are paid in small amounts and at intervals instead of lump sum. They are generally included in the price of the commodity and hence the burden of these taxes is not felt very much by the taxpayers. They are convenient from the point of view of the government also, since the tax amount is generally collected from the manufacturers or the importers.
- **Elastic** – Indirect taxes can be elastic i.e. the revenue from them can be increased. Whenever the government may desire to do so, provided that these taxes are imposed on those articles, the demand for which is inelastic. However, the principle of inelasticity and ability to pay generally conflicts against each other. For instance, if heavy taxes are imposed on articles of common consumption i.e. the demand for them is inelastic, they will fall more heavily on the poor than on the rich. On the other hand, the items of luxuries cannot be taxed heavily as their demand may be elastic.
- **No Evasion** – Indirect taxes are generally difficult to be evaded as they are included in the price of the commodity. A person can evade indirect tax only when, if he decides not to purchase the taxed commodity. However, indirect taxes can sometimes be evaded through smuggling and maintaining false accounts.
- **Can be Progressive** – Indirect taxes can be made progressive by imposing heavy taxes on luxuries and exempting articles of common consumption.
- **Wide Coverage** – Through indirect taxes, every member of the community can be taxed, so that everyone may provide something to the government to finance the services by public utilities. Hence, with the help of indirect taxes, the tax system can thus be made broad based.
- **Productive** – The income from indirect taxes can be made highly productive, by imposing few taxes, each yielding a substantial amount of revenue. It may easily be possible, if taxes are imposed only on those commodities the demand for which is inelastic. But it should be noted that it may have adverse distributive effects.

Social Welfare

Heavy taxation on articles which are injurious to health and efficiency of the people may restrict their consumption. For instance, the heavy taxation on liquor and other intoxicants may restrict their use, which obviously is in the interest of the community as a whole. All these things emphasize that indirect taxes are good taxes in a tax system when they are productive, convenient and approximately equitable. They are paid with less irritation than direct taxes. Revenue can be raised in multifarious ways by means of indirect taxation and the basis of taxation is thus broad based.

Demerits of Indirect Taxes

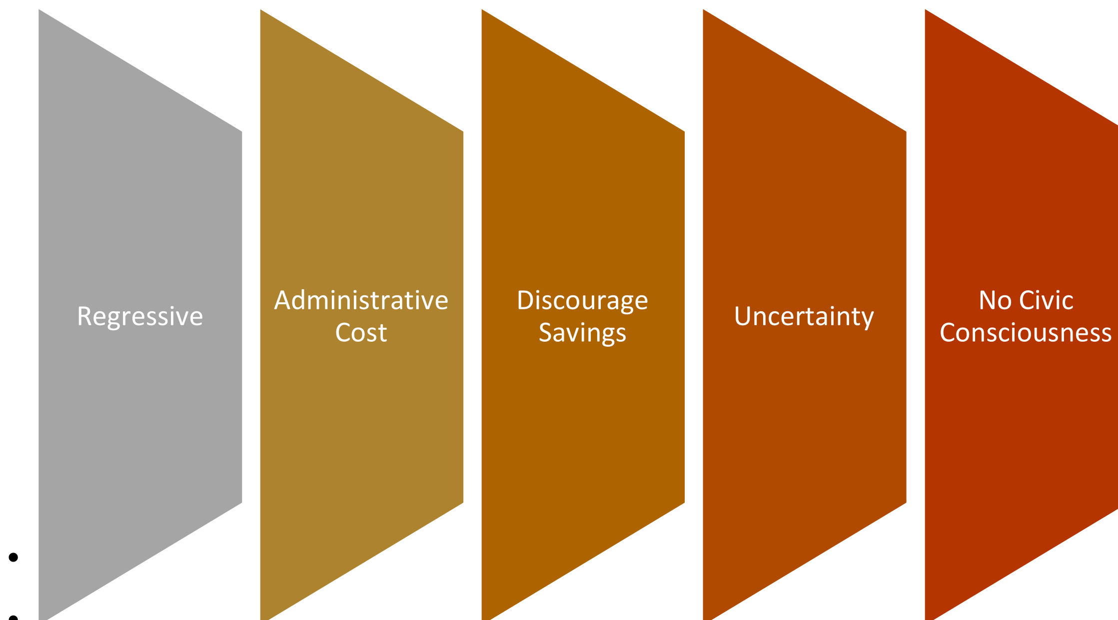


Figure 3.4: Demerits of Indirect Taxes

- **Regressive** – The indirect taxes are generally regressive in nature as they fall more heavily upon the poor than upon the rich.
- **Administrative Cost** – The administrative cost of collecting such taxes is generally heavy, because they have to be collected from millions of individuals in small amounts. Therefore, they may be uneconomical.
- **Discourage Savings** – Indirect taxes discourage savings, because indirect taxes are included in price and therefore people have to spend more on essential commodities. Hence, they discourage savings.
- **Uncertainty** – The income from indirect taxes is said to be uncertain, because the taxing authority cannot accurately estimate the total yield from different taxes, on account of the fact that the demand for different goods subject to taxes, is influenced by so many factors. If the demand for these goods is elastic, the income maybe less and vice versa.
- **No Civic Consciousness** – Indirect taxes are collected through middlemen like traders, and hence they have no direct impact. They are also collected in small amount; hence they are not felt very much by the taxpayer and do not arouse civic consciousness.

It is considered an indicator of financial virtue of the taxing authority, if a balance between direct and indirect taxes is maintained. Generally, the burden of indirect taxes tends to fall more heavily on the poorer sections of the economy. Burden of direct taxes is mainly on the richer sections of the community. In modern economies most of the direct taxes impose greater contributions from the rich

than from the poor in proportion to their incomes and opposite is the case with many indirect taxes. But sometimes it is possible that the burden of direct taxes may fall more heavily on the poor and that of indirect taxes on the rich. Thus, no value judgement can be passed on the relative merits of direct and indirect taxes which are alternative means of achieving income distribution. We, therefore, agree with Gladstone, the great Victorian Stateman, who remarked that the direct and indirect taxes should be viewed as equally attractive sisters, neither of whom should be pursued too ardently. The government should pursue both with proper and appropriate grace. Most of the economies of the world keep a good combination of direct and indirect taxes.

Comparison of Effects of Direct and Indirect Taxes

Direct and indirect taxes are now compared on the basis of (a) allocation of resources, (b) administrative point of view and (C) distributional effect.

- **Allocation Effect**

It is generally maintained that allocative effects of indirect taxes are inferior to those of direct taxes. It implies that, if a given amount of money is to be collected through taxes, the burden of the tax or the sacrifice involved would be greater in case of indirect taxes than direct taxes. Let us now analyze it with the help of a diagram, using indifference curve techniques.

Now suppose a particular amount of money, say SQ_2 is to be collected through the taxes; it can be collected through an indirect tax, say excise duty as well as from a direct tax, say income tax. Now we have toanalyze whether the consumer will get better satisfaction (or will be subjected to less sacrifice), if he pays it through excise duty (indirect tax) or through income tax (direct tax).

Comparison between direct and indirect taxes

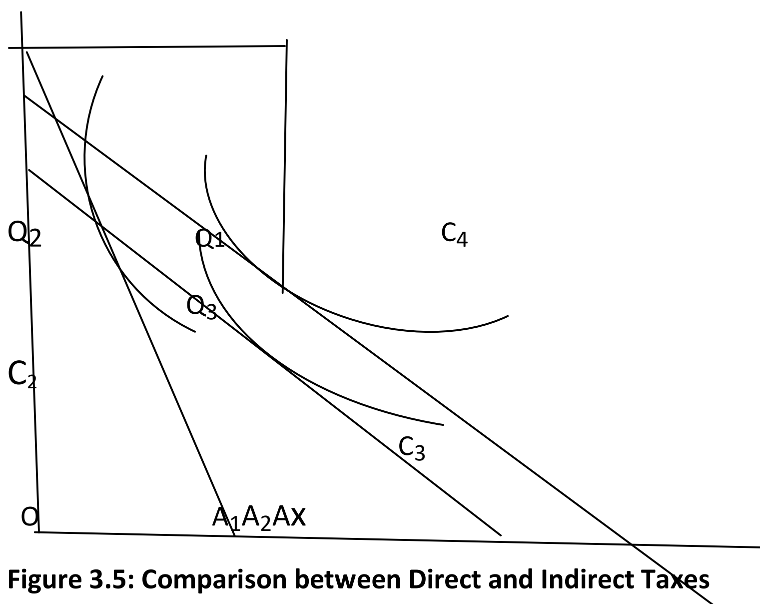


Figure 3.5: Comparison between Direct and Indirect Taxes

Source: Tyagi, 1985

In the diagram below, X-axis represents a commodity – X, while Y-axis represents the income of an individual. OP is the given income and PA is the price line. C_1 is the indifference curve, which touches the price line PA at the point Q_1. Thus, the consumer with OP amount of income will be able to purchase OA amount of commodity – Y. But he will be in equilibrium at the point Q_1, where he is able to purchase PN_1 amount of commodity, X by incurring N_1 Q_1 amount of money. This is a condition when no tax is imposed, or he does not pay any tax.

Now suppose an excise duty is imposed on commodity -X and it is included in the price, so that the increase in price is equal to the amount of tax imposed. But with the increase in price of the commodity X, the consumer is able to purchase less at his present monetary income OP. Suppose, with OP amount of money (income) he is able to purchase, OA_2 amount of commodity X. Hence, the new price line would be A_1P. It is the result of excise duty on commodity X, because of which he is able to purchase less than before. C_2 is the indifference curve, which touches the price line PA_1 at the point Q_2. Thus, the consumer is in equilibrium at the point Q_2. Now the consumer can buy only N_2amount of commodity – X, whereas before taxation he has to spend only N_1Q_1 amount of money to purchase PN_1 amount of commodity X. Thus, he spends more and gets less in line of his total expenditure Q_2N_2, SQ_2 is paid as excise duty to the government. Thus, SQ_2 is the difference between

the old and new price lines PA and PA_1 respectively. It implies that the amount of excise duty and the change in the price are of the same magnitude.

Now, the impact upon the consumer, when the same amount of revenue SQ_2 is collected by the government through a direct tax, say income tax instead of excise dutyhas to be observed. In this case, the consumer's disposable income is reduced by the amount of tax SQ_2. Therefore, SQ_2 is deducted from the original price line PA, or income line PA, we get a new price line P_1A_2 or a new income line P_1A_2 (since $SQ_2 = PP_1$). But in this case the price of the commodity does not change as a result of the direct tax or income tax. Therefore, the new price line P_1A_2 is parallel to the original price PA. C_3 is the indifference curve, which touches the new price line P_1A_2 at the point Q_3. But C_3 is higher indifference curve than C_2. Therefore, the disutility in case of indirect tax is greater than that of direct tax of equal amount. In other words, a consumer gets greater satisfaction under direct taxation than under indirect taxation.

- **Administrative Aspect**

A comparison between direct and indirect taxes can be made from the point of view of administrative cost and efficiency. Generally, direct taxes are not imposed on low incomes because of administrative point of view. For instance, in India, majority of people in villages are exempt from income tax because of extremely low levels of income. Therefore, we cannot approach each individual through direct taxes, because of their unpleasant nature and administrative cost. Hence, from the point of view of administrative cost, direct taxes are considered superior to that of indirect taxes.

Many Economists have supported indirect taxes on the grounds of administrative cost and stated the circumstances in which indirect taxation maybe more suitable. In case of large number of small, unorganized and independent producers or illiterate population incapable of maintaining accounts, barter system exists and most of the people are living at subsistence level, indirect taxation is preferable to direct taxation. These conditions exist in a developing economy. However, this does not show the

weakness of direct taxes compared to indirect taxes in all respects but that the environment does not suit optimum revenue collection with direct taxes.

- **Distribution Aspects**

Direct and indirect taxes may be compared on the basis of distribution effects. Direct taxes are considered as an important instrument to remove inequalities of income and wealth as they are generally progressive in nature. Hence, they gall more heavily on the rich than the poor. On the other hand, indirect taxes fall on all incomes; and hence, they are generally regressive in fall on all incomes; and hence they are generally regressive in nature. Therefore, indirect taxes are generally not suitable from the point of view of removing inequalities of income and wealth.

However, it does not mean the indirect taxes cannot be made progressive. They can be made progressive by imposing heavy taxes on those consumer goods which are generally consumed higher income groups and exempting those goods which are of common consumption. It is therefore concluded that both direct and indirect types of taxes have their own merits and none can be regarded as inferior to the other. Thus, Prof Prest concludes that, "over a wide range, direct and indirect taxes are alternative methods of achieving any particular redistribution of income on which the government of the day may be bent."

The most important factor in taxation is the estimation or ascertainment of an individual's income for determining the amount of tax that a person should pay. If an individual's income is directly appraised or ascertained, it is a direct tax. He, however, was of the view that direct appraisal of taxable income is not always possible or exact, and many people may evade the appraisal of income in whole or in part. The income which escapes from direct appraisal may be appraised indirectly at the time when it is spent.

Direct and indirect taxes are at best complimentary to each other.

Direct appraisal of income usually results in a figure which is less than the true income, but if it were less than the true figure by the same amount in case of all incomes, the problem would be resolved by raising the tax rate sufficiently to cover the need and it would be unnecessary to have a recourse to indirect taxation. In fact, however the errors of underestimation are not equal for the taxpayers of the same category and still less equal for taxpayers of different categories. To remove these errors and to distribute the burden of taxation equally, it is very much desirable to appraise the income both directly and indirectly. Direct and indirect appraisal of income will reduce the inequalities in the distribution of burden of taxation, which is greater only when direct appraisal of income is in force.

Proportionate, Progressive, Regressive and Digressive Taxes

Direct taxes could be classified on the basis of the proportion of progression or distribution of their burden on the taxpayers. On the basis ofthese criteria, taxes may be classified as proportional, progressive, regressive and digressive. A tax is called progressive when, with increasing income the tax liability not only increases in absolute terms, but it also increases as a proportion of income falls with the increase in taxpayer's income, it is termed as a proportional tax. If the tax liability as a proportion of income falls with the increase in tax-payer's income, it is termed as regressive tax. But, in the case of

progressive tax, the absolute tax liability of the taxpayer will increase. In the case of digressive taxation, there is a declining degree of progression as the tax base increases.

Proportional Tax System

Under proportional tax system, all income is taxed at a single uniform rate. Whether the taxpayer's income is high or low is not considered. For instance, if the rate of income tax imposed is 15 per cent, all individuals have to pay the income tax at that rate and no change in the rate of tax with the increase or decrease in income. Proportional tax system is simple to impose for the Government, and simple to understand for the tax payers as there is a single uniform rate of taxation.

For instance, even if the income tax of many individual taxpayers with differing income has to be paid, the amount of tax they have to pay is of the same proportion. The rate of tax which all will be required to pay is 15 per cent of their income. Before the tax, given that the relative status of individualtaxpayersis different, after tax has been imposed and the tax amount has been collected by the government.The relative status of the persons remains of the same difference, given that the rate remains constant at all income levels. It can be shown diagrammatically as follows:

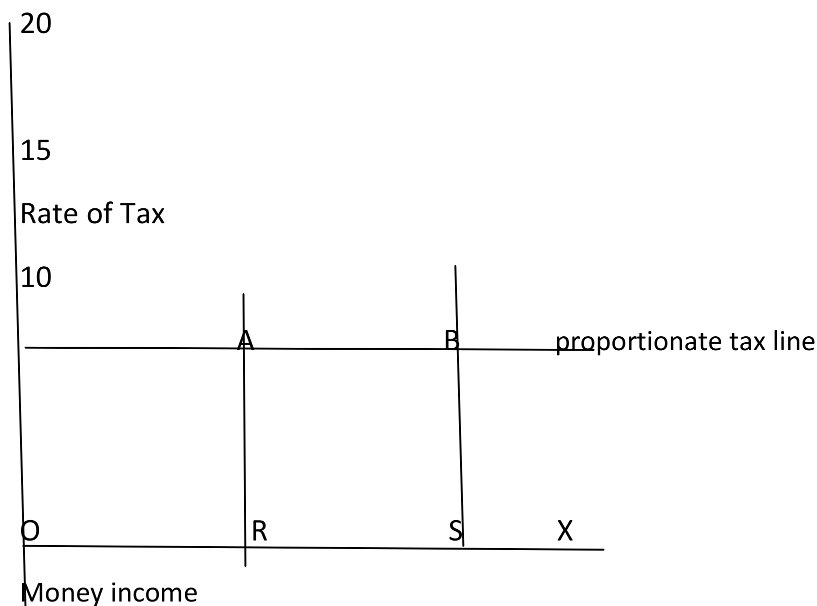


Figure 3.6 Rate of Tax

Source: Agarwal, 2004

Thus, a proportional tax manifests the feature that It is levied in a fixed percentage. Its proportion does not change with the change in taxpayer's income and wealth.

Merits of Proportional Tax

Following are the main advantages of proportional taxation.

- It is easy for every individual to evaluate the total amount of tax he has to pay. The tax payers can easily and quickly calculate the amount of tax they have to pay to the government.

- The proportional tax is simple and easy to understand. Even a person with an ordinary intelligence can understand its implication without any difficulty.
- There is no change in the existing distribution of income and wealth in the society as a result of proportional tax because all the taxpayers pay the tax at a single uniform rate of their incomes. It is neutral with respect to income and wealth distribution and consequently it involves no structural change in the socio-economic set up of the country.

Proportional Taxationinherit the following Draw Backs

- In the case of proportional taxes, the burden of tax falls more heavily on the poorer sections of society. The reason for this is that as the income of an individual increases, the marginal utility of money for him diminishes. In other words, the marginal utility of money for the rich is lower than the marginal utility of money for the poor. If the rich and the poor are taxed at the same rate, obviously the poorer sections of society will be making greater sacrifice than the richer section. Consequently, the proportional tax system does not satisfy the important canon of equity and justice in taxation.
- The system of taxation does not reduce the inequalities of income and wealth, rather it enhances these inequalities and increases the gap between haves and have not's.
- It is not in accordance with the principle of taxable capacity
- It contributes less to the public exchequer

Progressive Taxation

A progressive tax is a tax which changes with the change in the income of the individual and the rate of tax becomes gradually higher for the increasing incomes and lower for the lower incomes. It does not give scope for a fixed and uniform percentage for all the income levels. If the income of taxpayer increases, the rate of tax also increases, and if the income decreases, the rate of tax also decreases. A schedule of progressive tax rates is one in which the rate of tax increases as the base (income) increases. Recognizing that the amount of tax paid is the result of multiplying the base by the rate in a progressive tax, the multiplier increases, and the multiplicand increases. Accordingly, the amount of tax paid will increase at higher rate than the increase in the tax base.

Following diagram shows progression of taxes:

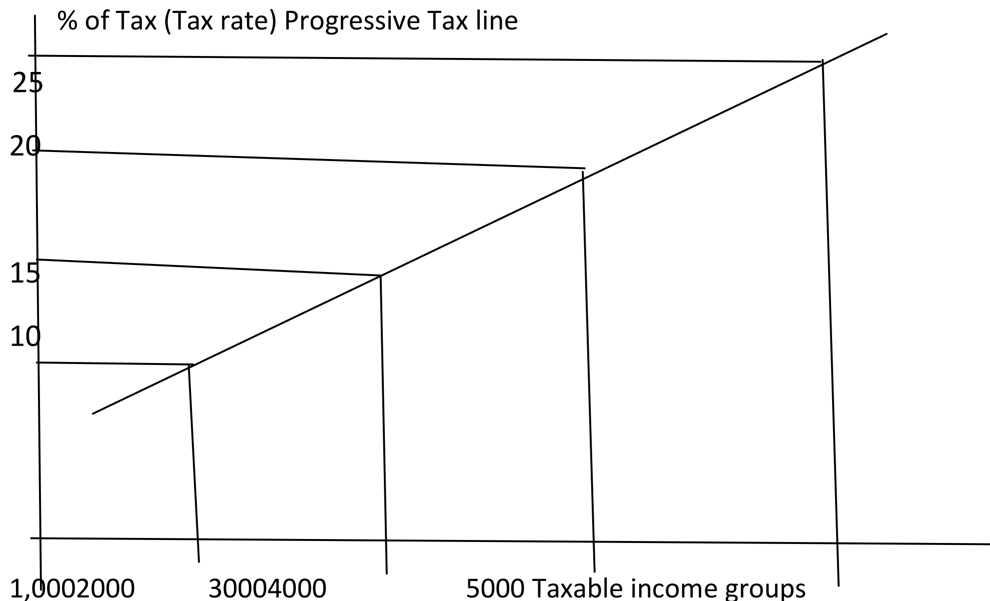


Figure 3.7 Progression of Taxes

Source:Tyagi, 1985

In the above diagram it is observed that an exemption limit is fixed under a progressive tax. Exemption limit in the figure is 1000.Consequently, all those persons whose income is less than the prescribed limit of exemption are granted exemption from the payment of tax. It is also evident that the rate of tax goes on increasing with the increase in income. The higher income group taxpayers are taxed at progressively higher rates. For purpose of taxation, individual incomes are divided into different tax slabs. Each slab includes tax assesseswhohave to pay tax at one specific tax rate. For each income slab, there is a different rate of tax and this rate of tax goes on increasing with the increase in income. In the diagram it is seen that people with 1000 till 2000 pay 10% tax. But people with income between 2000 and 3000 pay 15%, people with income I3000-4000 pay 20% Highest tax slab in this example is 25% which is imposed on people with income between 4000-5000.The upward rising straight line at the meeting point of each income group and tax rate is called progressive tax line as the rate increases with increasing income. Above this level the tax is said to be regressive tax because people above 5000 do not have increased tax rate. It is for this reason that a progressive tax is also sometimes referred to as a "graduated tax."

Merits of Progressive Tax

Most of the economies of the world at present implement progressive taxation as they are welfare economies. Its popularity is due to the advantages which are experienced by the stake holders. Main advantages are given below:

- A very strong case for progressive tax rates exists in terms of the ability to pay and the corresponding sacrifice which taxation involves. Here, it is assumed that the marginal utility of income is subject to reduction as income rises. Since the ability to pay increases in direct proportion to the increase in income, the rate of tax goes on increasing with every increase in the

size of income. Progressive taxes are in line with the principle of 'ability to pay' and concerned sacrifice that taxation is backed by. It is based on the assumption that marginal utility of income declines with the rise in income. As ability to pay increases with every rise in income, the tax rates imposed.

- People with higher income are expected to pay higher taxes. Middle class pay minimum taxes. The poor are exempt from taxation. Therefore, it is said that income and wealth are distributed in a more equitable way under this system. Richer persons are required to pay the tax at a higher rate than the poorer persons. So, the distribution of income and wealth is more equitable under this system.
- This mode of taxation is economical because significant amount of funds is mobilized into the Government treasury by increasing tax rates, without high cost of collecting tax.
- Mild upward and downward changes in tax rates bring about higher changes in tax revenues>this shows elasticity of progressive taxes.
- Social Justice is promoted to the optimum extent as people are taxed in accordance with their ability to pay. Progressive taxes are designed in such a way as to impose equal marginal sacrifice (additional sacrifice from one slab to the next). So, the tax policy means justice to thewhole society as also to the individual tax payer.

Important Demerits of this Tax are as below

Following are the prominent Demerits of Progressive Taxes Progressive tax has often been disputed on the ground of non-measurability of utility. Marginal utility of net incomes of different persons cannot be measured in such a way as to permit precise comparisons between individuals. So, it is impractical to discover any faultless objective standard of progression or gradation of tax rates on the basis of subjective utility.

Progressive Tax does not consider the Benefit Received Principle: When we consider the welfare activities of the government, benefit received by people is not clear. As per this approach, the government should tax the poor people more because of the benefits received from its welfare activities. Even if the welfare functions of the state are ignored, it cannot be evidenced whether the rich or the poor derives the maximum benefit from the state activities

The degree of progressive taxation has an important bearing on the process of saving and capital formation in an economy. The critics of progressive taxation state that it is only the rich who can save and, therefore, if they are taxed more heavily than the poor, the saving potential will either be lost completely or reduced significantly. Consequently, the process of capital formation declines due to progressive taxation.

It is observed thatunderprogressive tax system, tax evasion and tax avoidance are rampant. The tax payers invariably try to evade the payment of the tax by presenting false statements of accounts before the taxing authorities and finding legal loopholes in the tax provisions.

Progressive taxation is now widely recognized as desirable as all economies cherish the aim of maximum welfare. Under progressive taxation, it is possible to eliminate or reduce the glaring economic inequalities in society. Economists like Alfred Marshall and John Maynard Keynes also laid special emphasis on progressive taxation as a means for increasing the volume of employment in society.

It is not practicable to make all taxes progressive. It is relevant to select appropriate taxes, rates and exemptions so that arbitrariness which can always be levelled against any progressive tax or rate, is reduced to the minimum. The principle of progressive taxation has less applicability in a developing economy, on account of the smaller number of people who have to pay direct taxation (income tax assesses). Due to this limitation, in a less developed economy, all the finance required for development cannot be raised only through progressive direct taxation on income and wealth and main reliance has to be placed on indirect taxation.

Regressive Taxation

Under regressive tax system, the higher the income of a tax payer, the lower is the proportion of his contribution to the government as tax. Thus, a regressive tax is categorically opposite to a progressive tax. Under this system of taxation, the poorer sections of society are taxed at higher rates compared to the richer sections. As the income of an individual increases the rate of tax also decreases. A schedule of regressive tax rates is that in which the tax rate decreases as the income increases. During French revolution, it is said the king imposed such taxes on the people. English salt tax during mercantilism is another example of a regressive tax. Indian income tax burden after the last tax slabis considered to be regressive. It is a strong argument to introduce one more tax slab beyond the existing highest tax slab as there are many who can contribute but squander the amount in super luxuries! The logic was that the poor consume with excess income but the rich save and invest with excess income! Therefore, it was considered logical for nation building.

Regressive tax system can be represented diagrammatically as shown in Figure below where the tax line is falling curve indicating the fact that as income increases the rate of tax falls.

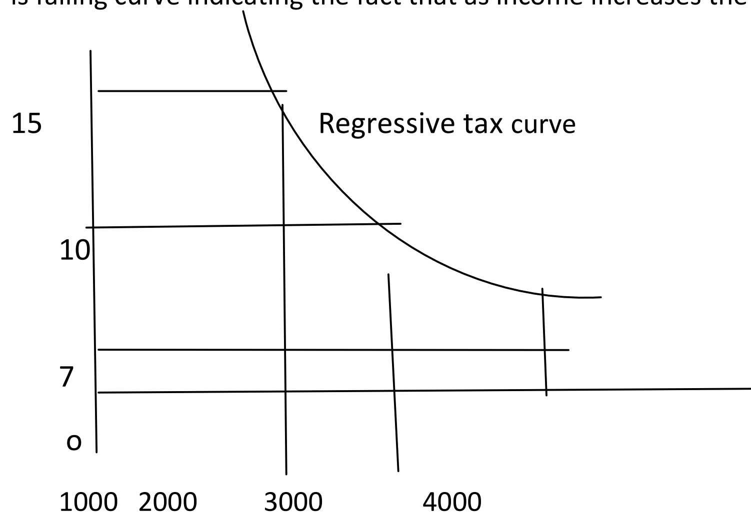


Figure 3.8 Regressive Tax Curve Source: Vaish&Agarwal, 1990

Thus, in a regressive system of taxation, the tax rate falls as the as the tax base (income) increases. The absolute amount of tax payable may, however, increase but at a decreasing rate and it may also decrease. Since this system of taxation is not just or equitable, it has been abandoned everywhere. The Salt Tax which was imposed by the British Government prior to 1947 in India and which was vehemently opposed by Mahatma Gandhi culminating in the historic Dandi March was an example of a regressive tax because its burden fell more heavily on the poorer sections of the society.

Digressive Tax

It could be called as a mild progressive tax. In a digressive tax, the rate of progression does not increase in the same proportion as the income. The rate of tax increases up to a certain limit beyond which a uniform rate is charged. Thus, the digressive tax is a blend of progressive and proportional taxation. The result of this tax is that the higher income groups make less sacrifice than the lower income groups. Indian income tax is said to be digressive because after the highest tax slab of assesses above 15,00,000 paying 30%, tax rate remains the same. The tax rate does not increase after 30%. So those who get income more than 15,00,000 pay the same rate as those who get an annual income of 15,00,000. So, at this level it is said to be degressive.

From the above analysis we can conclude that a progressive system of taxation is the best system of taxation. Most advanced countries of the world now-a-days follow this system of taxation. India is also gradually adopting the progressive system of taxation.

Table 3.1 Tax Slabs

Tax slabs as per current budget amount in Rupees	
<2,50000	Nil
250,001-5,00,000	5%
5,00,001-7,50,000	10%+12,500/
7,5001-10,00,000	15%+37500/
10,00,001-12,50,000	20%+75,000/
12,50,001-15,00,000	25%+1,25,000/
Above 15,00,000	30%+ 1,87,500/
Source: Finance Ministry: Budget 2020	

Specific and Advalorem Taxes

On the basis of base of taxation, commodity taxes are classified into Specific Tax and Ad Valorem Tax.

Specific Tax

When a tax is imposed on a commodity on the basis of its weight, size or measurement, it is called a specific tax. When the excise duty is imposed on agricultural produce based on weight or the cloth is taxed according to its length it is known as a specific tax.

The main merit of specific tax is that it is easy to levy and more convenient to collect because it is collected either according to the weight of the commodity or according to the size of the unit of the commodity. The main disadvantage of this tax is that it imposes a greater burden on the poorer people than on the rich people. The reason is that the marginal utility of money for the rich people is lower than that for the poor people.

Advalorem Tax

When the tax is imposed on a commodity according to its value, it is termed as ad valorem tax. Whatever be the weight or size of the unit of the commodity, the tax is charged according to its value. Examples are precious metal products, electronic goods and handicrafts. This tax brings into tax net, those commodities which have low weight but are high in terms of economic value such as electronic goods, IT products, Android products, precious metals, handicrafts etc.The main advantage of an ad valorem tax is that it imposes a greater burden on the richer sections. Hence, from this point of view, ad valorem tax is more equitable.

The main issue with an ad valorem tax is that it is difficult to know the real value of the commodity at the time of imposing the tax. Generally, the traders understate the value of the commodities in their invoices in order to escape the burden of the ad valorem tax.In fact, it is difficult to choose between a specific and an ad valorem tax. A good tax system should have both, specific as well as ad valorem tax, according to the nature of the commodities.

Single and Multiple Taxes

Taxes can also be classified into (I) Single Tax and (ii) Multiple Tax

Single Tax

A single tax occurs in a system in which the taxes are levied only on one subject. There is only one tax which constitutes the source of public revenue. The Physiocrats in their prime of glory in the eighteenth century had strongly supported the single tax system in France. According to them, the aim of the government is to catch up those who create surplus and consequently to tax them. They held that tax is always paid out of surplus. The leading physiocrats Francois Quesney and A Famous Physiocratic Economist, Anne Robert Jacques Tourgot supported the single tax system and proposed that taxes should be levied on economic rent of land as it was a surplus out of which taxes could be paid. Consequently, they levied the entire tax burden on rent which in their view was purely a surplus accruing to the landlords. In the nineteenth century, sociologist Henry George also supported the idea of taxing the land partly on economic grounds and partly on ethical grounds. According to Henry George, a tax on land did not check industry. But this idea was criticized by the other sociologists who pointed out that the rich people, in order to save themselves from the burden of tax without land, would be taxed less whereas poor people with land would be forced to pay tax and if it happens, it is not fair.

A single tax on income can be devised with advantage. It can yield adequate revenue and avoid unfairness in the distribution of the burden of taxation by means of graduation, differentiation and other devices. There are, however, three serious objections to such a single tax. Firstly, it would be difficult and expensive to collect, particularly in relation to small incomes. Secondly, it would secure no

special contribution from the inheritors of wealth. Thirdly, it would check saving more than other taxes would do.

Following are the main disadvantages of a single tax system:

- It would not produce adequate revenue.
- It would mean a very unsatisfactory distribution of the burden of taxation. In case of land as the base, millionaire owing no land would completely escape the burden of tax while a poor person who invested all his savings in the purchase of land would pay a proportionately very high tax.

Multiple Tax

Economists and policy makers now widely acclaim the multiple tax system because a single tax system presented many difficulties. It proved inefficient in solving the real purpose behind a good tax system. A multiple tax refers to the tax system in which taxes are levied on various items. It is absolutely against the single tax system. It can be easily seen why this must be so. A modern economy is not one or single objective economy. It tries to forge ahead simultaneously along the paths of growth, equitable distribution of income and wealth, economic stabilization, etc. Since no single tax can be expected to help the economy on all fronts, choice for a multiple tax system becomes inevitable. Different taxes contribute to the attainment of different objectives. Thus, some taxes would help in the more equitable redistribution of income and wealth while some other taxes would help the economy in the direction of regional balanced growth. Some other taxes may still be required to provide adequate revenue for the government treasury.

Merits of Multiple Tax

- There is least scope to evade taxes with multiple tax rates. Therefore, multiple tax rates are considered as an efficient fiscal policy to tackle tax evasion and tax avoidance.As the tax implements imposition of tax at every point of high income, it can be drafted to be devoid of discrimination among socio economic groups leading to decline in inequality of income and wealthof taxation.
- Implementing multipletaxation system can give the policy makers enough cope to correct the disadvantage of one tax with another tax having advantage for the disadvantaged group.For example, there were Finance Ministers who did not reduce the tax rate but increased the exemption limit of income tax. Budget 2020has reduced corporate tax rate and removed dividend tax to encourage investment with impending recession, to counter removal of all deductions in income tax in thecurrent budget.
- Under this tax system there can be taxes with diversified tax base (tax base refers to the no of people bearing the burden of a tax. If a greater number of people bear the burden, such a tax is said to be broad based. A tax with a smaller number of people bearing large burden of tax is said to be narrow based. This system of taxation is in accordance with the principle of flexibility. It

provides for innovative and new taxes in a dynamic macro-economic scenario. With multiple tax policy non feasible and out dated taxes can be discontinued.

Above conducive aspects make multiple tax system almost always preferabletosingle tax system.

Demerits of Multiple Tax System: Inspite of the above stated superiority of the multiple tax system, too great a multiplicity of taxes is undesirable and should be avoided.

Large number of taxes, howsoever small based, would involve a high cost of collection and administration (account keeping+monitoring).Therefore, it is considered to be preferableo depend on a few revenue earningtaxes.It is often said that taxing income and inheritance of the rich and at the same time collecting GST imposedon commodities and services with inelastic demand but not essential for health and efficiency of common man, is the optimum combination under multiple tax system in a welfare economy

Large number of tax just in order to raise revenue acts against simplicity principle.Thisleavesthe tax system complex and confusing rendering it inconvenient to pay taxes.This has negative effect on productivity of taxes. Consequently, tax avoidance and tax evasion get rampant in such a system.As a it is a sample direct tax mobilizing high revenue to the exchequer and progressive in nature, it is considered essential to understand income tax computation and its details in a nut shell.

3.2 Federal Taxes

India adopted Federalism at the dawn of independence. Federal structure was accepted as given in the Constitution in 1950.As given in article 280 of the Constitution, Central Taxes are given in Union List as receipts of the central Government and there were 12 taxes mentioned in the list. They are stated as revenue receipts and capital receipts. Taxes are the most important sources of revenue receipts. But based on the recommendations of the Finances Commission, a portion of tax receipts of Union Governments are statutorily transferred to the states. The types of taxes of Union Government may be divided into three. One type includes taxes on income and expenditure like income tax, corporation tax and expenditure tax on hotel income etc. The second type includes taxes on property and capital transfers like estate duty, wealth tax, gift tax etc. The third type includes taxes on commodities and services called for a long time as Central Excise and now included in GST and Customs duties. The first two are categorized as direct taxes and the last one is an indirect tax. In addition, there are other non-tax receipts ofrevenue of central Government.

State Taxes are given as receipts of state Governments in the State list.20 taxes are mentioned in the state list. Like the Centre, sources of state revenue also are classified into revenue receipts and capita receipts. Revenue receipts are taxes on income like agricultural income tax, professional tax, stamp duties and registration duties, land revenue, urban immovable propertytax and surcharge on cash crops. Other than these direct taxes at state level, they also have indirect taxes at state level on commodities and services called state GST such as sales tax, electricity duties,entertainmenttax, etc. States also have sources of non- tax receipts. But as per article 286, States cannot levy taxes on exports and imports of

India and sales of goods which areannounced by law as essential for life of the community. Apart from state taxes, states get shares of revenue collected through certain Union taxes and through grants in aid.

Federal Taxation of India connotes three tier fiscal systems. But only fiscal transfers from Centre to states called vertical transfers and transfers among states called horizontal transfers are clear. Flow of Funds to the local government has not clearly evolved. States transfer funds to local Governments. The amount of funds collected at local level is not sufficient to allow for independent functioning of local Governments. 14thFinance Commission allowed for transfer of funds directly from Union Government to local Government for the first time. This move provides for more independent decentralized governance at local level.

There can be more innovative taxation at local level with growth income at this level. There is also need to revisit traditional self -sufficient Indian village model of Gandhian Economics of Rama Rajya and Manorial system of Europe can also give some insights for collecting local taxes with good performance of local governments which will form foundation of federal taxation in India.

3.3. Evolution of Federal Taxation

Indian tax system has been evolving from ancient times. But it was not the main source of revenue during ancient kings. Kings had their own assets and estate besides revenue receipts from tax and non -tax revenue. It has not been studied much for policy guidelines. Most of our present tax practices are of British heritage. There are statements in Rig Veda advising that Kings should collect taxes from the subjects without causing inconvenience to them. Known Indian systematic tax structure can be traced to Sher Shah of Suri dynasty. He divided his kingdom into tax districts. Emperor Akbar is credited with forming provincial revenue structures for tax collection and designated his trusted Rajput kings (vassals) to head them. It is said the flow of revenue to the treasury was smooth.

The provision for federalism for India is made in the Country's written Constitution. The financial powers of different levels of federal governance are clearly defined in the constitution, at the final phase of growth of Federal Finance in 1950 after Indian independence. But this is the result of evolution of federalism over the past century, from absolutely centralized financial powers to the present system of federal finance. This evolution could be seen in the form of the following five periods:1833-1870, 1871-1918, 1919-1935, 1936-1945 and 1950 onwards.

1833-1870: During this period, there was complete centralization of financial powers by the charter act of British Government. It made provisions for collection of revenue on behalf of Indian Government. Complete centralized powers vested with the Governor General. None of the State Governments in the economy had any financial or legal powers. The system showed acutedefects.All financial sanctions even for small amounts had to be approved by the Governor General.There was bias in governance. As the states did not themselves collect taxes, they depended on the grants from the Governor General.

1871-1918: Acute financial uncertainty prevailed. Uniform grant- in- aid extended by Governor general was not suited for a populous and large economy like India. Lord Lytton, in 1977 introduced new financial instruments to boost the strength of provisionalGovernments.It is during this period that taxes

like Excise duties and stamp duties (which grew in importance after Indian independence) were added to grants in aid. The revenue receipts of states were mostly inelastic. In 1882, Lord Rippon some resources were given to states while others were distributed between the Centre and the states. This was called revenue collected under ‘divided heads’. The same year Lord Rippon abashed fixed grant system. The system was to be reviewed once in five years. Financial resources which included taxes were in three forms:

i. Imperial heads constituting profits from commercial engagements and receipts from opium, salt and customs,
ii. Provincial heads including civil departments and provincial works and divided heads.
iii. Divided heads representing revenue from excise duties, assessed taxes, stamps, forests and registration. It was in addition to grants in aid from the Central Government.

1919-1935: During this period there was marked dynamics towards decentralized finances well consolidated under ‘Montego-Chelmsford Reforms’ of 1919 which was implemented in 1921.There was clear provision for delineation of financial powers of the Centre and the States.States were allotted revenue from important sources like Land Revenue, Estate Duties, stamp and irrigation charges. It was estimated that with this financial separation Centre would experience fiscal deficit. Some states were to help the Centre with specific portions of their revenues: Madras: Rs. 4.28 crores, United provinces Rs.3.74 Crores, Bombay 21 Lakhs and Bengal 69 lakhs. This caused unrest among the contributing states which complained to ‘Financial Relations Committee’ which was appointed for the purpose. It submitted final report called as ‘Meston Award’. The award laid specific criteria for financial help to states, help by Centre to states and the repayment of debt from Centre to states. Entire income tax raised by the Centre was to be retained by the Central Government.

1936-1949: Stipulations were continued till 1935, when again the principles governing distribution of powers between Centre and states were reviewed. He Act of 1935 laid the foundation for Independent India’s federal financial power distribution and autonomy of provincial governments. But princely states remained outside the scope of this federal financial system.

Constitution The act of 1935was water shed period for Indian federalism. It demarcated clear financial receipts to the respective states such as Land revenue, irrigation charges, Excise duties on alcoholic liquor, Narcotic drugs, opium, toilet and medical preparations, stamps and registration charges as well as agricultural income tax. The Central Government was allotted the resources flowing from Corporation Tax, Customs Duties, Railways and Telegraph, Telephones, Broad Casting, Coinage, Currency as well as militaryreceipts.Some taxes were to be collected by the Centre but the proceeds were to be transferred to the states.A few more taxes were to be levied and collected by the Centre but to be distributed among the states. There were some tax resources to be collected by the states but to be distributed between Centre and the States. States which needed more financial help were to be allotted grants in aid. Till India became independent, recommendations of Sir Otto Niemeyer invited to enquire into Centre State relations in 1936were operational.

1950 onwards: Written Constitution provided for sharing of financial powers and resources between Central Government and state Governments. It also provided for equal distribution financial powers and resources among the states. The financial provisions of Act of 1935 were continued. A Finance Commission was to be appointed every five years which reported to the President of India. This constitutional body (Finance Commission) was to give the new financial distribution after hearing from the states and Union Governments about the existing financial arrangements. Recommendations of Finance Commission were to be made to the President of India about the shares of income tax and other taxes to be transferred to the states, about the sharing of financial resources among the states and about payment of grants in aid to states.

Till the constitution came to operation, for two years C.D. Deshmukh Commission was set up. It made recommendations limited to adhoc sharing of income tax proceeds among states. Deshmukh award helped India to tackle issues arising out of sharing jute export duty which had declined due to partition as India had lost jute growing areas to Pakistan during partition.

After the Constitution started functioning Union list consisted of taxes of the Government of India and States List constituted taxes and other financial resources flowing to the states from the Centre. It also includes states own taxes and grants in aid to states from Centre. Ever since Finance Commission pronounces changes in allocation of financial resources to Centre and states which are carried through by Union and States. Next important changes in evolution of taxes came in 1991.There were moves towards liberalization, privatization and globalization. By this time states started generating their own financial resources and role of grants in aid had declined. Tax rates were reduced. Excise duties were reduced to around 58%. Customs were reduced. Income tax exemption limit was raised. Innovative taxes which were waiting for decades were introduced; like Minimum Alternative tax, Presumptive Tax, etc.The number of Central Excise duty rates for different commodities were reduced towards the principle of simplification of taxes. Several changes were made in tax rationalization, standardization and simplification. Fiscal Responsibility and Budgetary Management Act (FRBM) stipulated that fiscal deficit should be less than 5% of GDP. In the first decade after year 2000 efforts to introduce Goods and Services Tax (GST) were initiated. In 2018 GST was formally introduced as CGST for Union and SGST for states. Introduction of GST harmonizes Indian commodity tax structure with rest of the world.

After a long time, tackling the issue that Company Taxes were high, the tax was reduced in the budget of 2020 adding productivity of the tax. It is interesting that Federal tax structure of India is still evolving.

3.4 Computation of Income Tax in India

If the income of an individual is below the basic exemption limit then he is not required to file income tax returns. Though those who have income less than Rs 2.5L and want to claim an income tax refund can only claim the refund by filing an ITR. Otherwise, it is mandatory to file income tax returns in any other case. The maximum limit of non-taxable income for an individual is set at Rs 2.5 lakh. However, you can also get a rebate of Rs 2,500 under section 87A if you have a total income of less than Rs 3.5 lakhs for FY 2018-19. From FY 2019-20 onwards, the rebate has been increased to Rs 12,500 for an income less than Rs 5 lakh. So, that means an individual earning less than 5 lakh will not be required to

pay any income tax from FY 2019-20 onwards. If you have tax saving investments under section 80C of up to Rs 1.5 lakh, then you will not have to pay any taxes till Rs 6.5 lakh.

Concept of Income tax

Income tax is a tax imposed by the government on the income of an individual in every financial year. To calculate your income, all the income sources like salary, business income, rent, dividends, etc. are considered. Every citizen of the nation or even a non-residential individual also has to pay this tax to the government if he is earning any income in India.The government of any country has various kinds of expenses like paying pension to government employees, building roads and infrastructure, start various schemes for the citizens benefit etc. For all this, they need money and income tax is one of the ways for the government to earn the money.

The same money eventually is used to run the nation and its development. So, when we pay the income tax, we get back various facilities like roads, public parks, and poor people also get various free services in health and education. Every individual, who has yearly income more than a limit (current limit of 2018-19 is 2,50,000 per year) has to pay some part of their earning as tax to the Income-tax Department.

Documents you need when you're e-filing your income tax returns

1. Basic information such as PAN, Aadhar Card details, and current address.
2. All the bank account details held in a financial year.
3. Income proofs like current salary details, income from investments (like FDs, savings bank account) etc.
4. All the deductions claimed under Section 80 or Chapter VI-A.
5. Tax payment details such as TDS and advance tax payments.

Calculating Income Tax

Calculating income tax needs depends on 2 main factors. (1) Taxable income and (2) Age Slab of the income tax assesses. An income Tax 'assessed' is an entity which has income that it is supposed to pay income tax.

Taxable Income

Tax is paid on "Taxable Income" and not your full income. There is something called "Exemptions" and "Deductions" which are reduced from your income to arrive at "Taxable Income".
Formula to calculate taxable income is given below:

Taxable income= Income from salary + income from property + income from profits or gains from business+ Income from capital gains+ income from other sources
Taxable income is income of an individual from all sources. They are normally classified into five sources mentioned in the formula and given below in the figure.

Gross Income

Gross income is one’s own total earning. It is the entire amount of your income without any deduction or exemptions. Gross income is the income you earn from all your earning sources. It is not only your salaried income.For instance, in one month, if your earned income is Rs.50,000 as salary, Rs 25,000 as your house rent and Rs.20,000 out of your other business, your gross monthly income will be: 50,000 + 25,000 + 20,000 = Rs. 95,000.

All sources of income are classified into 5 categories. The categories are called 5 heads of income as shown in the figure below:

Figure 3.9 Sources of Income

Source: Taxman

Heads of Income

Each and every source of earning from where you are getting money is considered as your income. There are 5 main sources which are also called as 5 heads of income which are considered as the main income sources. These 5 heads are as bellow:

1. **Income from Salary**

The first head is “Income from Salary”, so if you are a salaried employee, then your whole year salary has to be added, less exempt HRA and other perquisites (covered below in this article) which are allowed to be tax-exempt. So, this amount is to be shown under the head of the salary. It does not matter if you are a government employee or work in the private sector

2. **Income from House Property**

If you have a property and you have given it on rent, then all the rent earned in a year will be considered as your “Income from House Property”.

3. **Income from Profit or Gains from Business**

If you have your own business, then all the profits you generate from that business will be considered under this head. For example, if you have a shop, and your revenue is 5 lakhs a year, but your expenses in shop is 3 lakhs, then your profit is Rs 2 lakhs. These 2 lakhs will be considered as your income under this head.

4. **Income from Capital Gains**

Capital assets can be simply defined as the property you own, which includes Stocks, mutual funds, real estate, gold, etc. So, the profit you earn through the sale of these assets is considered as a capital gain and it will be taxable depending upon the class of asset from which capital gain occurred. For example, gain on capital assets like equity stocks or equity mutual funds are taxable at 10% above Rs 1 lakh profits in a financial year.

5. **Income from Other Sources**

The sources of income other than the above-mentioned classes are looked into, under 5th head of income. The money you receive from any relative or friend as a gift above Rs 50,000 or any award prize or lottery you won, etc. will come under this head. Salaried people, mostly, will not have to deal with the other 4 heads of income for several years.

Deductions and Exemptions

These two things can be reduced from an individual's gross income and one's taxable income can be reduced, resulting in lower taxes.

Table 3.2 Table showing Tax exemptions and Deductions

Source*

Sections	Meaning	Maximum limit (in Rupees)	Claimant
80C	Deduction on investment made in LIC, PPF, ELSS, ULIP, Payment towards Loan principal, tuition fee, etc.	1.5 Lac (for 80C, 80CCC, 80CCD)	HUF & Individual
80CCC	Deductions for premium paid for annuity	1.5 Lac aggregate	Individual
80CCD	Contribution to National pension scheme	50,000 above Rs. 1.5 Lac limit	Individual
80CCF	Deduction on investments in infrastructure and other tax-saving bonds	20000	Individual & HUF
80CCG	Rajiv Gandhi equity savings scheme (RGESS)	25000	Individual & HUF
80D	Deduction on premium paid for Medical insurance	25000 (50,000 in case of senior citizen)	Individual & HUF
80DD	Deduction on medical expenses of dependent handicapped relatives	75,000 in case of general disability (1.25 Lac in case of severe disability	Resident Individual & HUF
80DDB	Deduction on medical expenses of self or dependent relative	40,000 (80,000 in case of senior citizen)	Resident Individual & HUF
80E	Deduction for interest on education loan for higher studies	There is no limit on the maximum amount that is allowed as deduction.	Individual
80EE	Deduction on interest paid for home loan only for first-time homeowners	Up to 3 Lac	Individual
80G	Deduction on donations for social causes	Limits are based on donations	All assesses
80GG	Deduction on House Rent when HRA is not paid	2,000 per month	Person who is not getting HRA
80GGA	Deductions for donations made towards scientific research or rural development.	Limits are based on donations	Taxpayers who have income from salary or property or capital gains and not from business
80GGB	Deduction on the amount paid to any political parties by companies	Limits are based on donations	Indian companies
80GGC	Deduction on the amount paid to any political parties by an individual	Limits are based on donations	Non-corporate assesses or taxpayers

80IA	Deductions in respect of profits and gains from industrial undertakings or enterprises engaged in infrastructure development	NA	All assesses
80IAB	Deductions in respect of profits and gains by an undertaking or enterprise engaged in the development of Special Economic Zone.	NA	All assesses
80IB	Deduction in respect of profits and gains from certain industrial undertakings other than infrastructure development undertakings	NA	All assesses
80IC	Special provisions in respect of certain undertakings or enterprises in certain special category States	NA	All assesses
80ID	Deduction in respect of profits and gains from business of hotels and convention centers in specified area	NA	All assesses
80IE	Special provisions in respect of certain undertakings in North-Eastern States	NA	All assesses
80JJA	Deduction in respect of profit and gains from business of collecting and processing of bio-degradable waste	100% of profit for 5 successive assessment years	All assesses
80JJAA	Deduction in respect of employment of new workmen.	30% salary of full-time employees for 3 years	Indian companies
80LA	Deduction in respect of certain incomes of Offshore Banking Units	Rs.12000 (plus additional 3000)	scheduled banks, IFSC and banks established outside India
80P	Deductions in respect of income of co-operative societies	NA	Co-operative Societies
80QQB	Deduction in respect of royalty income, etc., of authors of certain books other than text-books.	3,00,000	Resident Indian authors
80RRB	Deduction on the income of Royalty of a Patent	3,00,000	Resident individuals
80TTA	Deduction from gross income for interest on savings accounts	10,000 per year	HUF and Individual taxpayer
80U	Deduction in case of physical disability	75,000 in case of general disability (1.25 Lac in case of severe disability	Resident individuals
24	Home Loan Interest	Rs.2 lakh (for self-occupied house) No limit (for let-out property)	Individuals

Exemption available to salaried employees on receipt of allowances and perquisites from employer could be explained as follows:

Tax Exemptions

"Exemptions" are some of the defined benefits or heads which can be deducted from income. A person spends on some of the necessities in life like paying rent, spending money on children's fees, and basic living expenses. So, some of the exemptions allowed are

- HRA (house rent allowance)
- Standard Deduction of Rs 50,000 per year
- Children Education Allowance + Hostel Allowance
- LTA (Leave travel allowance)

Tax Deductions

There are various deductions under different sections of the income tax act. This deduction is against amounts that you have invested in some specific products like Insurance, ELSS (Equity Linked Saving Scheme), or ULIP (Unit Link Insurance Plan), Public Provident Fund(PPF) and it also considers specific types of expenses that you incurred during a financial year like Principal repayment of loan, donations or health insurance premiums, etc. You can see various sections covered under section 80 (from 80C, 80D up to 80U), their meaning, maximum limit of deductions and who can avail the benefit of these deductions.

An example of calculation of taxable income of a person who's total earning is Rs.12,60,000 is given below:

Person 'A's gross salary	Rs. 12,60,000
His deduction under 80(C) acts	Rs.1,50,000
HRA benefit	Rs.60,000
Standard Deduction	Rs.50,000
Taxable income formula	Gross income – exemption – deduction
	12,60,000 (Gross income) – 1,50,000 (Deduction) - [60,000 – 50,000 (Exemption)]
Total taxable income	10,00,000

From this example we got Rs.10,00,000 as a taxable income of that person. Thus, taxable income is estimated.

Income tax stated in a budget, is applied on that taxable income (explained and estimated above).

The second factor essential for income tax calculation is your age. According to the age groups, there are three tax slabs and each tax slab has different tax rates. See below these three tax slabs and yours.

Tax slab below 60 years of age group

In this group comes the youngsters both men and women having age below 60 years. Individuals in this group have to pay more tax than the other groups. Here the tax rate is highest among all three groups. See the table below (Table 3.3) to understand the tax rate –

Tax slab between 60 to 80 years of age

This is the group of individuals most of whom are already retired. In this group tax charges are different i.e. lower than the first group. The percentage of tax is given below.

Tax slab above 80 years of age

This is the last and most aged tax payer's slab. The tax rates are lower here than the other two groups. The percentage of tax is given in the following table (Table 3.3):

Table 3.3 Tax Slab for Seniors and Super Seniors

Individual Residents (seniors and super seniors under the previous tax regime)		
Income in Rupees	Above 60 & below 80	Above 80 years
Upto 3,00000	Nil	Nil
3,00,000-5,00,000	5%	Nil
500,000-10,00,000	20%+10,000	20%
Above 10,00,000	30% + 1,10,000	30% +1,00,000
Source: Finance Ministry Budget document		

Income tax is applicable for a financial year. Financial year is one year's period for which accounts are filed (income and expenditure are filed {as a balance sheet} by individuals, Companies and HUF {Hindu Undivided Family}). It begins from
1st April and ends on 31st March in India. In USA it is calendar year.

Last date for filing income tax returns is normally last day of March. To file ITR this year, date is extended to last day of June due to Covid.

Income Tax Calculation

Tax slab is the income which falls under one tax rate. In 1st tax slab, as per old regime, Income upto Rs.2,50,000 is tax free.

(between Rs. 2,50,001 to 5,00,000) 5% tax = 5% of Rs. 2,50,000 = Rs.12,500

(between Rs 5,00,001 to 10,00,000) 20% tax that means 10,00,000 – 500000 = 5,00,000

Tax at 20% on 5,00,000 will be = Rs. 1,00,000

If we take the same above example of taxable income of Rs 10 lakhs and considering this person his income tax can be calculated as follows. The total income tax of this person will be –

Rs. 12,500 + Rs. 1,00,000 = Rs. 1,12,500 (plus Education cess of 4%)

Complete tax calculation could be explained in the steps below:

If the person is earning more than 10 lakhs, then on the amount above Rs 10,00,000, it will be taxed at 30%.

Table 3.4 Tax slab as per current budget

Tax slabs as per current budget amount in Rupees	
<2,50000	Nil
250,001-5,00,000	5%
5,00,001-7,50,000	10%+12,500/
7,5001-10,00,000	15%+37500/
10,00,001-12,50,000	20%+75,000/
12,50,001-15,00,000	25%+1,25,000/
Above 15,00,000	30%+ 1,87,500/
Source: Finance Ministry: Budget 2020	

TDS (Tax Deducted at Source)

When you earn an income beyond a specified limit, the government has mandated the person paying you the income to deduct one part of it as your advance tax on your behalf is called TDS.If you want to find out all the TDS deducted for you at one place, there is a form called form 26AS which can be downloaded from TRACES website. You can claim the TDS amount against the total tax payable by you.

In case your TDS amount is more than the tax payable, you can apply for the tax refund when you file your ITR (Income Tax Returns).

Various Income Tax Return (ITR) forms

After paying the income tax, one also has to file the IT return which is to declare your income earned from various sources, tax paid in advance, your TDS deducted in the financial year. It is also useful for claiming income tax refund.

There are different ITR forms for each class of individual i.e. salaried, or business/professional individual. Following is a brief classification of ITR forms –

ITR 1 or Sahaj: It is a form for an individual (Resident) earning less than Rs. 50 Lakhs in a financial year under heads of Salary or pension, one house property, Other sources (excluding winning from Lottery and Income from Race Horses) and agricultural income less than Rs. 5000 in F.Y.

ITR 2 : This form is for HUF and an individual (including non-resident/resident not ordinarily resident) who is earning more than Rs. 50 lakhs under head of Salary, House property, Other Sources (including Winning from Lottery and Income from Race Horses), agricultural income more than Rs. 5000 in F.Y. and also capital gains.

ITR 3: This form is used by HUF and resident individuals who have income under the head of Profit & Gains from business or profession. This return may also include income from house property, salary/pension and income from other sources.

ITR 4: This return form is to be used by an individual or HUF, who is resident other than not ordinarily resident, or a Firm (other than LLP) which is resident, whose total income for the assessment year 2019-20 does not exceed Rs.50 lakh and who has income computed on presumptive basis under section 44AD or 44AE or 44ADA.

Differences between IT Payment as per Previous Budget and 2020-21 Budget

Union Budget 2020 offers individuals the option of paying income tax under the new regime of lower income tax rates by forgoing the tax exemptions/deductions or continues to pay tax under the existing income tax laws by claiming the applicable exemptions and deductions. Essentially, the more exemptions an individual claims, the less likely he/she is to benefit from the new optional tax regime however which regime is beneficial will vary on a case to case basis. Calculations show that salaried individuals claiming a large number of exemptions are likely to be better off in the existing income tax regime.

An individual with gross salary up to Rs 12.5 lakh claiming only deductions under section 80C (Rs 1.5 lakh), 80D (Rs 25,000) and a standard deduction of Rs 50,000 will pay more tax under the new personal

income tax regime. Lower the gross salary, higher the additional tax payable by individuals in the new tax regime claiming only these three exemptions (up to the amounts mentioned) in the old tax regime. Individuals claiming little as tax breaks are more likely to gain from the new regime. Actual loss or gain for taxpayers opting for new tax regime is to be calculated individually because the amount of exemptions/deductions claimed by them will vary.

Salaried Individual not Claiming any Exemptions or Deductions

Assuming no tax deductions or exemption are claimed in the existing personal tax regime, the individual with gross salary of Rs 7.5 lakh would save tax of Rs 15,600 if he/she opts for the new personal taxregime. At Rs 10 lakh, the individual would save Rs 28,600 in tax and at Rs 12.5 lakh he/she would save Rs 49,400. An individual earning Rs 15 lakh or above will save Rs 62,400 tax.

Table 3.5: Year on Year (YOY)change in tax regime –for salaried individuals not claiming any exemptions or deductions

Source: Budget 2020

Gross salary income level	**Tax payable in Existing Regime**	**Tax payable in New Regime**	**Additional tax saving**
At 7.5 lakh	54,600	39,000	15,600
At 10 lakh	1,06,600	78,000	28,600
At 12.5 lakh	1,79,400	1,30,000	49,400
At 15 lakh	2,57,400	1,95,000	62,400
At 20 lakh	4,13,400	3,51,000	62,400

“If the salaried individual is claiming deductions under section 80C, 80D (medical premium), HRA exemption, LTA exemption and deduction of interest paid on housing loan taken for self-occupied property up to permissible limits, he is likely to be better off in the existing personal tax regime,” said Shalini Jain, tax partner, EY India.

Salaried individual claiming most common deduction/exemptions, i.e. under sections 80C, 80D and standard deduction

Assuming the individual is claiming these tax breaks: standard deduction of Rs 50,000, deduction of Rs 1.5 lakh under section 80C and Rs 25,000 under section 80D for medical premium. In this case, if the

individual opts for the new personal tax regime then at gross salary of Rs 7.5 lakh the person will have to pay Rs 20,800 extra tax, at a gross salary of Rs 10 lakh the additional tax payable will be Rs 7,800 and at a gross salary of Rs 12.5 lakh the additional tax payable will be Rs 5,200. However, at a gross salary level of Rs 15 lakh or above the individual will save tax of Rs 7800.

Therefore, a high earner claiming only these deductions is likely to save tax under the new regime but lower-income earners up to the gross salary of Rs 12.5 lakh will end up paying more tax.

Table 3.6: Change in tax Regime for salaried individuals who claim--common deductions and exemptions

Source: Economic Times, 2020

Gross Salary Income	Existing Regime	New Regime	Additional Tax Saving
At 7.5 lakh	18,200	39,000	(20,800)
At 10 lakh	70,200	78,000	(7,800)
At 12.5 lakh	1,24,800	1,30,000	(5,200)
At 15 lakh	2,02,800	1,95,000	7,800
At 20 lakh	3,58,800	3,51,000	7,800
At 7.5 lakhs	–	39,000	(39,000)
At 10 lakhs	28,600	78,000	(49,400)
At 12.5 lakhs	70,200	1,30,000	(59,800)
At 15 lakhs	1,11,800	1,95,000	(83,200)
At 20 lakhs	2,34,000	3,51,000	(1,17,000)

3.5 Evolution of GST and Computation of GST

Taxes levied on goods and services were called indirect taxes consisted of Central Excise and Customs collected by Union Government. At state level, State excise and sales tax were collected. These taxes were wrought with complexities. There were multiple rates for different commodities and services. After new economic policy of 1991 was initiated globally, the taxes were called GST. In international trade, need to harmonize with rest of the world was persistently felt by both policy makers and academicians alike. This is because 140 economies levy GST as their indirect tax system. In 2006 for the first time the then Government expressed the need to change Central excise to GST to fall in line with global practices. There is need to reduce the number of tax rates on goods and services to simplify and rationalize the indirect tax structure. It was announced that from 2010GST would come operation. But

political exigenciesdelayedthechange.GST was introduced only in May 2015. The tax is evolving. Flaw less GST will need time to evolve.

GST is the modernized form of indirect taxes.Itis a tax levied on all points of supply of goods and services with credit allowed for any tax paid on input procured for use in making the supply. It is a destination-based tax. The tax has key impact on customers, vendors, pricing, inventory management, profit/loss, cash flow, accounting, IT systems, contract management and process.

Chapter Summary

This chapter is about how taxes are divided on the basis of impact and incidence; taxes are classified into direct and indirect taxes. In fact, this is the most popularly used division of taxation. If impact and incidence is on the same entity it is a direct tax. If impact is on one entity which shifts the burden to another entity, such taxes are called indirect taxes. All commodity taxes come under this category. On the basis of degree of change in rate of taxation, they are divided into proportional, progressive, regressive and digressive taxes. Large number of taxes imposed in welfare economies are progressive n nature. On the basis of whether the base of taxation is weight or value, taxes are classified into specific and advalorem taxes. When merits and demerits of each type of tax are introspected and they are also compared with the counterpart if the tax is found to have more merits than demerits and better than its counterpart, policy makers continue with the tax. If not, taxes are discontinued. The most important tax in terms of tax revenue and ability to pay, income tax is explained further. Computation of income tax summarized. Using taxable income, different heads of income, deductions and exemptions income tax calculation is explained in a simple way. Current year's income tax slabs and rates are stated for understanding of the learner.

To Do Activity

Discuss if it is possible to live without paying tax? Who and where is it possible?!
Students can be shown web sites of Central Board of Direct Taxes, GST and Customs
Office of Central Board of Direct Taxes, GST and Customs
Students can be asked to draw graphs for each type of tax
Students can be asked to draw graph for comparison of merits of direct and indirect taxes
Students can be asked to read out revenue productivity of Indian Corporate income tax and other countries list as per OECD data as in the table above
Students can be shown various ITR forms and could be asked to fill them

Model Questions

1. Define the Following:

Direct Taxes, Indirect Taxes, Single Tax System, Multiple Tax System, Progressive Taxation, proportionate taxes, Regressive Taxes, Digressive taxes. Give one example for each type.

2. Mention any 4 direct taxes
3. Explain the merits and demerits of Direct and indirect taxes with a graph. Which is better type of taxes
4. Explain the merits and demerits of progressive, proportionate and regressive taxes with graphs
5. Explain merits and demerits of Single taxation and multiple taxes. Which is preferable for an economy?
6. Describe the types of taxes an economy can implement to collect maximum revenue
7. Mention the 5 heads under which income is taxed. Define each head
8. What do you mean by Taxable income?
9. What is gross income? Give an example
10. What are deductions under income tax returns?
11. What is Tax deduction from source?
12. What are the age-based tax rates for senior citizens in the current budget and previous budget?
13. Explain the computation of income tax returns
14. What is an income tax slab?
15. What is income tax rate?
16. What do you mean by 'income tax assessee'?
17. Mention the months when financial year begins and ends in India
18. Is Indian income tax progressive discuss
19. What is 'income tax returns' filing?
20. Mention any 4 exemptions of income tax.
21. What are the differences of income tax filing in 2019 budget and 2020 budget
22. For which sections of population filing income tax returns as per old tax regime is beneficial and for which sections 2020 income tax returns filing is beneficial. Discuss
23. Expand TDS, ITR and HUF

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Chapter 4 Federal Tax System

Introduction

Federal fiscal transfers are the essence of Federal Fiscal policy. It functions according tothe administrative structure that economy assumes through the Constitution. India is declared as a leading federation among the welfare economies of the globe. Federal tax system is an essential part of evolution of Federalism in the economy. To work through the administrative and financial system of Indian economy, It is practically binding to know the meaning, nature and functioning of federal tax system as most developed economies like USA have federal system of governance. India adopted federal fiscal system with clear demarcation between Central Government and regional Government with the Centre exerting dominance over regional Governments, during British colonization. After independence, it developed over federal form of governance and fiscal policy. Understanding the systems within it involves delving into three stages of governance, the Union Government with its own receipts, sharing a portion with the regional Governments and local Government, while exerting controls over them and directing them towards the main aims of the economy. It is essential life time learning for the students to know about federal tax system. It is of interest to look into the needs of seekers of decentralized governance of finances with specific reference to local governance.

Objectives

- To explain the meaning of Federalism.
- To present to them the evolution of federal taxation so as to appeal to their young minds to know the system in which they operate in future.
- To explain computation of GST
- To familiarize on State Tax Receipts
- To give a brief picture of trends in federal taxation

Chapter Structure

4.1 Evolution of Indian Federal Tax System

4.2 Receipts of the Central Government

4.3 Computation of GST

4.4 State Tax Receipts

4.5 Trends in Indian Federal Taxation

4.1. Evolution of Indian Federal Tax System

A federation is a form of Government in which the supreme political power (sovereignty) is distributed among the central and regional (state) Governments in such a way that each government within its sphere of functioning is independent of the other. Under this system there is sovereignty withthe Centre and under it are different regions. Functions of these units are determined with well-defined way in the constitution.

Economies like Canada, South America, Australia and Switzerland are older federations. Some form of federalism suited to their needs, is practiced later by India, Pakistan, Malaya and Nigeria. Federalism is often called an 'American invention' because modern form of federalism is influenced by the experience of United States in the years 1776-1789. But the constitution makers of USA drew the ideas to a large extent from British Empire, Greece and United Netherlands. Federation is form of Government where there is association of two or more states. In federal form of governance, Union or central Government is for the whole country.

There are State Governments across the country. Constitution stipulates how the exact powers of the governments should vary. Exact Government powers and obligations differ in different federations. Federal Finance requires that federal Government fulfills its responsibility towards states utilizing its own financial powers within its jurisdiction. Federal Government is expected to follow the principles of uniformity, autonomy, fiscal sufficiency and flexibility, efficiency and economy as well as equity in executing the functions towards incumbent states. But the principles have to be followed with discretion.

There is a certain degree of interdependence in the finances of the Centre, states governments. Therefore Alfred Deakin says "The rights of self –government of the states have been fondly supposed to be safe guarded by the constitution. It left them legally free, but financially bound to the chariot wheels of the Central Government". It follows that federalism is based on division of powers on the basis of written constitution and there exists supremacy of the constitution.

Constitution of India follows the mode of division of tax payers between Centre and states. Our federalism is an inspired combination of models of USA and UK. Indian federalism began with British Charter act with the Governor General of Bengal in 1833 and evolved ever since, for more than 170 years. After the dawn of independence in 1947, Indian constitution granted the financial provisions as in the act of 1935. A Finance Commission had to be appointed every five years r earlier as per the President's notification. Finance Commission considers existing arrangements and listening to the views of states, makes recommendations to the President about the shares of income tax and other taxes of Central Government to be allotted to the states and the distribution of shares among the states, along with the payment of grants in aid to state revenues. Immediately after constitution formation, Financé Commission could not be formed. So, the then Government of India invited C.D. Deshmukh to examine the division of tax revenues between the Centre and states. C.D.Deshmukh submitted his award in January 1950 specifying the determination of share of States out of income tax proceeds which had to

be shared equally among states. This award was implemented only for two years till the first Finance Commission submitted its recommendations about the same matter.

However Deshmukh Award filled gap of urgent need for distributing the resources after partition of India. States were formedto have a wide variety of powers. But residual powers of taxation vests with the Central Government. The flow of funds from Union Government to the state and then from States to local Government is called devolution of resources. Indian federation is a three tier structure. But the flow of funds from state level to local Government is not clearly stated. First three decades after independence, states were found depending to a large proportion, on grants in aid from Centre. But there is increasing dependence on other sources over the decades.Local Governments are found depending on state Government for resources. Finance Commission is a constitutional body determining the devolution of funds Centre to states and local Governments.

To meet increasing developmental needs, the feasible method of resource mobilization lies in the instrument of additional taxation. Indian is based on federal structure. That is, three tier tax structure consisting of union or central finances, state finances and village finances. The Government at each of the above levels has set functions to undertake. There are specific means of raising resources for the expenditure at each level. There is transfer of resources from Centre to states and from states to local government. Such a flow of resources from one level of federal governance to the other is called devolution of resources. These transfers happen through three channels. Foremost of these is through the constitutional body of Finance Commission. Finance Commission recommends transfer of a portion of central tax revenue to the states. It also recommends extension of grants in aid to states. Second source of fund flow is through Planning Commission (now NITI) which extends loans and grants. Third source is through various ministries which provide funds for various central Government schemes.

4.2. Receipts of the Central Government

Most prominent source of receipts of Central Government is classified into revenue receipts and capital receipts. Most important form of revenue receipts is tax revenue. A part of tax receipts is transferred to states as per the recommendations of the Finance Commissions. Central Board of Direct Taxes (CBDT) implements direct taxes of Union Government.

The different types of taxes allotted to the Centre can be classified into three types on the basis of the basis of levy; namely, one: taxes on income and expenditure including income tax, corporation tax, expenditure tax on hotels etc. The second: are taxes on property and transactions including estate duty, wealth tax etc. The third type is the taxes on commodities and services covering excise duties, customs etc. The first two categories belong to the group of direct taxes. The third is in the group of indirect taxes now called Goods and Services tax (GST). From 2018 roll out of GST was initiated in India. GST includes excise duties to a large extent and service tax along with corresponding duties on imports. GST was developed as a concept to harmonize with global indirect tax practices from 1990s. 2018-2019 Budget of was the first budget after the roll out of GST. the Union list of taxes (list II) has 12 items of taxation. Though the above taxes are all Union list, the proceeds of the taxes are not retained by the Union.

Taxes in Union List

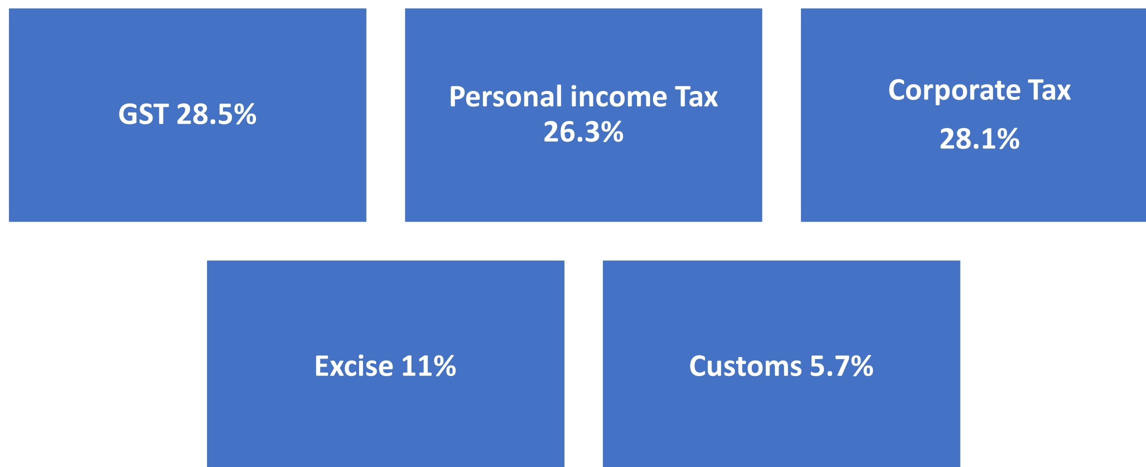

Figure4.3 Taxes in Union List

Source: Central Government Budget Document 2017

Taxes on PersonalIncome (explained under direct taxes in previous chapter)

According to income tax act of 1961, every assessee whose income exceeds the maximum exemption limit has to pay income tax. The tax is imposed during each assessment year.The assessment year starts from 1st April and ends on 31stMarch.Assessees are divided into individuals, Hindu Undivided families (HUF), Associations of Persons (AOP) , Body of individuals (BOI) Company, firms, local authority..Union Budget announces the tax structure and tax rates every year. It is calculated under five heads namely business and profession, house property, salaries, capital gains and other sources.

Indian financial crisis of 1857 led to the enactment of income tax in its modern form in 1860, to provide resources to overcome financial difficulties. First income tax was put on statute books in 1860.Till 1866 this tax had uneasy existence (it was abolished one year and imposed in another year. It was withdrawn again and reinforced next year.

In 1877 it existed with a new name {'license tax'}).But income tax act of 1886 had continuous track of existence for 30 years till 1916.In 1916 graduated income tax was imposed due to First World War. Different categories of income were imposed with different rates. This act saw replacement in 1918 and then again in 1922.The income tax act of 1922 introduced a machinery to and mechanism to administer

the tax and its rates by initiating ‘annual finance acts’. This provided much needed flexibility and elasticity to the tax system, to adjust to changes introduced in annual budgets. Before this change, to change income tax rates, income tax act itself had to be amended. The act of 1922 remained on statute books for 40 years till 1961.But the act of 1922 was amended several times till 1960. The act of 1961 is in force, in current India. As income tax is an important source of finance to both Centre and States, through economic development of India, both Union and States are interested in optimizing this source of federal finance. So it has undergone several structural changes and growth over time.

Corporate tax: In India Corporate tax is defined as the highest effective rate for corporate income of domestic Companies amount of this tax is based on net income obtained by Companies through their business activities normally during one business year.Corporate income tax is a relevant source of revenue to the Union Government. Budget announced effective Corporate tax rate for domestic Companies in India as 25.17 including surcharge and cess for such domestic Companies. Domestic Companies were levied with reduced tax rate of 22% from 30% applicable from the fiscal year that began on 1st of April 2020.

So far, Companies had to pay ‘dividend distribution tax’ (DDT)of 15%.Including surcharge and cess effective DDT would amount to 20.56%.Budget 2020 removed DDT. Budget 2020 provides for taxing e-commerce at a standard rate of 1%applicable on gross amount of sales or services or both.For the first time e-commerce is brought under tax net.

Expenditure Tax:As per Expenditure tax Act of 1987, all chargeable expenditure that an individual incurs on Hotels or restaurants will be taxed. The criteria are that if the room rent is Rs.3000 or more.Services from such a restaurant are also taxed at a rate of 15%.Hotel expenditure is also taxes by the states because of which the tax is criticized as ‘double taxation’.

Estate Duty: it was a tax levied on the total value of property held by an individual calculatesat the time of death.It was levied on the transfer of such property.It was repealed because the administrative cost of the tax was more than the returns. Returns were low because people successfully escaped the tax by paying gift tax during life time.However different versions of the same tax are existent like inheritance tax.

Gift Tax:This tax was introduced in 1958.Gifts of the value below Rs. 50,000 are not taxable. But if the gift exceeds Rs. 50000, the whole value of the gift would be taxed. Gifts to spouse, siblings and parents are also exempt from this tax. But it was repealed in 1998.

Wealth Tax: It was introduced in 1957 to reduce inequities.If the net wealth of an individual exceeds Rs.30Lakhs, such a person will have to furnish returns of net wealth and pay 1% wealth tax on the exceeding amount.In 2015, it was repealed as it was not productive.A surcharge of 12% is levied instead. In 1990 most of the OECD countries levied wealth tax.But now they have all discontinued the tax and have resorted to inheritance tax.India doesnot have even inheritance tax.

Customs Duty: Union Government of India is empowered to levy customs duty as per Customs on exports and imports procedures for importing and exporting , offences and penalties act of 1962.Central

Board of excise and Customs deals with all matters pertaining to customs duty.Before 1991, Customs duty was highly graduated at more than 120% and multiple rates were levied. New Economic Policy of 1991 reduced Customs to 58%. Current budget has increased Customs on consumer goods imports.

GST:GST is a single broad based comprehensive tax levied on goods and services at each point of supply of goods or provision of service.It was a tremendous leap from the complex structure of Commodity taxes before its initiation in 2017. Through this, the seller or service provider may claim the input credit of tax which he has paid while purchasing the goods or availing service. The consumer will only bear the burden of GST charged by the last dealer in the supply chain.With the initiation of GST at state level, the service tax would be comprehensively removed .Major Central and State Taxes are constituted into GST which reduce multiplicity of taxes.Thus it marks a significant improvement over the previous practice of VAT.With a complete chain of supply points, GST will assist in widening tax base and therefore encourage compliance.Higher tax revenue is logically anticipated.With international competition, GST provides foot hold in international trade.

4.3.Computation of GST

GST is levied on all points of supply.If one is a registered supplier, he (taxable person) has to pay GST. If he is eligible to register, he has to produce Aadhar card, Business ID,Bank account details location of Business and the component of GST applicable to their Business that is, whether CGST/SGST/IGST. One has to confirm if he is supplying input or output to transact credit and accordingly transact credit. Businesses exempt from GST should be checked. Applicability of his GST rate applicable to his business has to be confirmed. Then GST return filing form can be accessed. He can personally file returns online or approach GST Suvidha Kendras which assist him to be GST compliant completing the three stages (registration, credit transaction and return reporting) of GST payment as shown in figure 4.2. The concepts related to GST payment are briefed with figures below.

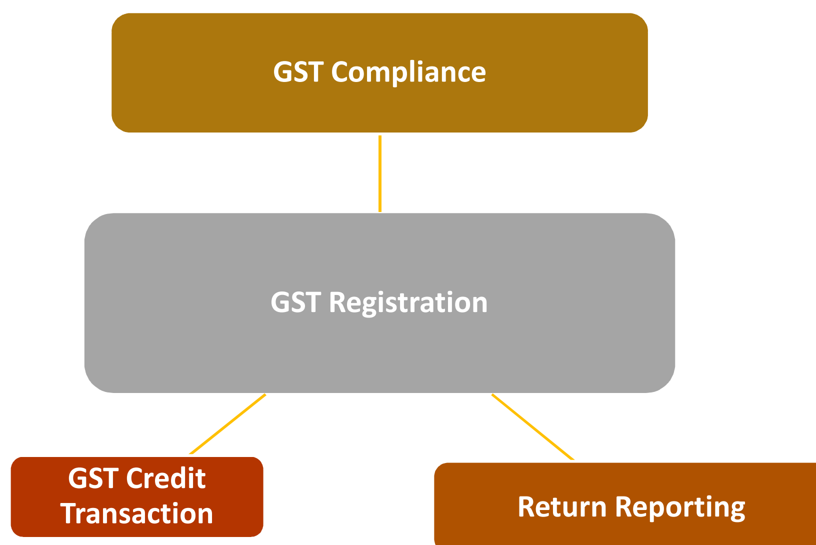

Figure 4.2 GST Compliance

GST Compliance involves GST Registration- GST Credit Transaction and Return reporting.

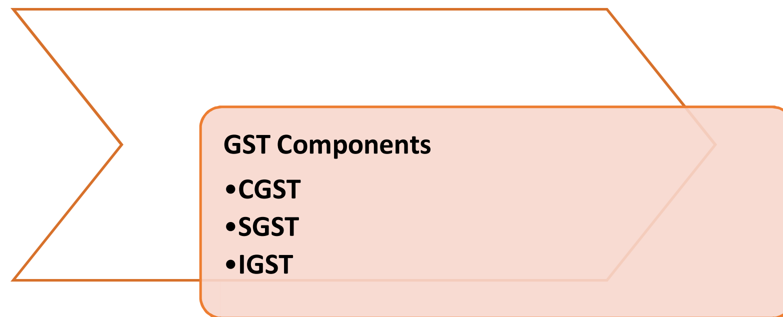

Figure 4.3 Components of GST

GST components: There are three components of GST CGST, SGST and IGST.Alcohol and electricity are not in the ambit of GST. Registration has to be done by taxable person, an entity or liable for registration GST Credit mechanism flows under the following heads.

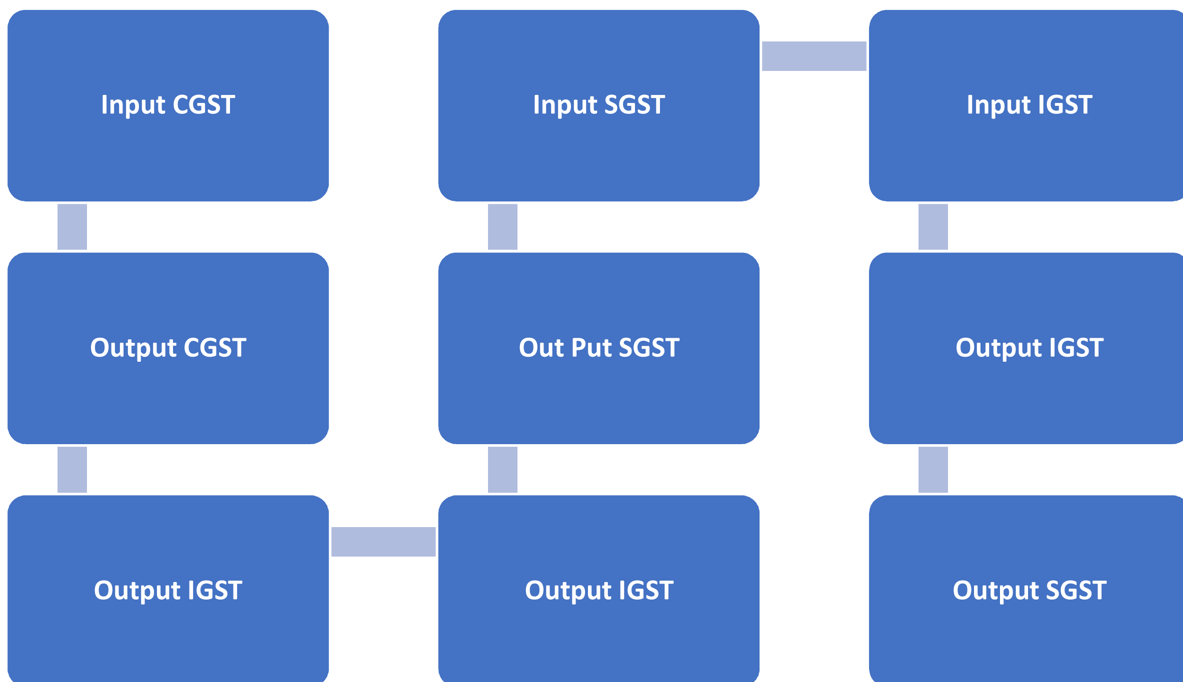

Figure 4. 4 GST Credit Mechanisms

- CGST cannot be credited against SGST and SGST cannot be credited under CGST
- Input SGST of one state cannot be available against SGST of another state

- Input GST in respect of services received allowed to be distributed to other states under the input service distribution mechanism.
- It not clear whether IGST and CGST credit of one state would be allowed against output IGST and CGST of another state

The following are exempt from GST:

Agricultural produce, supply to exempt goods, goods and services of a supplier below Rs.20 Lakhs, handicrafts and reverse charge supply.Reverse charge supply is that where the consumer directly pays GST to the Government.

Moving towards indirect tax simplification through GST, there are 5 tax rates 0%, 5% 12% 18% and 28%

Table 4. 1 Commodities and Services

Commodities & services	GST Rate
Aparel below Rs.100, foot wear below Rs.500,packaged food items, cram,skimmed milk powder, branded paneer, frozen vegetables, coffee, tea, spices, pizza, bread, rusk, sago, cashew nuts with shellraisin, ice,fish fillet, kerosene, coal, medicine, insense sticks, postage, fertilizers, rail and economy class air tickets, small restaurants etc. 14% goods and services are in this category.	
Supply of food and drinks(SF&D) served in restaurants not provided with facility of air-conditioning (AC) and central heating system, any time of the year, not having license to serve liquor	12% with ITC
SF&D in restaurants having liense to serve liquor, with AC	18% with ITC
SF&D in restaurants in 5 star or above rated hotel	28% with ITC
SF&D in restaurants having AC or central heating system at any time of the year	18% with ITC
Bundled service by way of supply of food or any other article of human consumptionor any drink in a premises (including hotel, convention hall, club, Pendal, Shamiana, or any other place specially arranged for organizing a function)together with renting of such premises	18% with ITC
Renting of hotels, inns, guest houses or any other commercial places for residential or lodging purposes with room rent is above Rs.5,000/night/per room	28%
GST Website	

Taxes in Union list are of 4 categories depending upon the degree of transfer of Union tax proceeds to the states. They are as follows:

1. Taxes imposed and collected by the Central Government and the proceeds of the taxes are wholly retained by the Union.Corporation Tax, Customs duties, taxes on capital value of assets exclusive of individual and corporate agricultural land are under this category. The proceeds of these taxes are not subject to federal transfer to states.
2. Taxes levied and collected by the union, states get share of proceeds of these union tax proceeds. Taxes on income other than agricultural income and (excise duties) GST on tobacco
3. And other goods manufactured in India with the exception of liquor and narcotics are included in this category. But sharing of income tax proceeds is obligatory. Sharing of GST proceeds is discretionary.
4. Some taxes are levied by the union but appropriated by the states. Stamp duties, GST on medicinal and toilet preparations.

Above categorization makes it clear that union is bound to share tax proceeds with states. The share of taxes could be increased or decreased as per the direction of Finance Commissions, is done on the basis of needs of the states. This proportion of share of states in central taxes has principles of administrative economy and efficiency, elasticity and adequacy, in collection of tax revenue.The Union taxes are transferred to the states through 'distributive pools method'. Following this method, predetermined proportions of the proceeds of Union taxes are combined into a single pool. Then these contents are allocated in predetermined proportions to states

In addition to tax revenue, there are other sources of revenue receipts including dividends from Railways and Telegraphs, Reserve bank of India, Public Sector undertakings, and interest receipts from Governments of states and Union Territories on loan. Towards capital receipts, the Governments havelegal powers, try sources like borrowing from domestic market and external markets and also from international institutions like IBRD and governments of rest of the world.

4.4.Receipts of State Government

Sources of state Revenues, like that of Centre are classified into revenue receipts and capital receipts.

Table 4.2Revenue Receipts of State Governments& Governments of Union Territories (UTs) in Rs.Lakh Crores

Revenue Receipts of State Governments& Governments of Union Territories(UTs) in Rs.Lakh Crores					
	2015-2016	**2016-2017**	**2017-2018**	**2018-2019**	**2019-2020**
Aggregate Receipts	22.99 (16.8)	26.47 (17.3)	27.76 (16.3)	34.29 (18.1)	37.63 (17.7)
Revenue Receipts	18.73 (13.6)	20.86 (13.6)	23.21 (13.6)	28.62 15.1	31.54 (14.9)
States own Revenue	10.35 (7.5)	11.18 (7.3)	13.10 (7.7)	14.92 (7.8)	16.55 (7.8)
State's own Tax revenue	8.80 (6.4)	9.46 (6.2)	11.30 (6.6)	12.69 (6.7)	14.09 (6.7)
State's own non-tax revenue	1.55 (1.1)	1.71 (1.1)	1.80 (1.1)	2.23 (1.2)	2.45 (1.2)
Central Transer(i+ii)	8.36 (6.1)	9.69 (6.3)	10.11 (5.9)	13.70 (7.2)	15.00 (7.1)
i.Tax Devolution	5.6 (3.7)	6.08 (4.0)	6.05 (3.5)	7.59 (4.0)	8.52 (4.0)
ii grants-in –aid	3.32(2.4)	3.61 (2.3)	4.06 (2.4)	6.11 (3.2)	6.48 (3.1)
Source: RBI Bulletin September 2019 State Finances Study of Budget of 2019-2020					

Taxes within State jurisdiction are given in list-II of 7th schedule. Taxes constituting revenue receipts of the states are the following: taxes on income like agricultural income tax, professional tax, taxes on property and capita and profession tax, taxes on property and capital transactions like stamp and registration, land revenue, urban immovable property, tax and surcharge on cash crops, taxes on trades etc. Other than these direct taxes, states have the power to levy indirect taxes like sales tax, electricity duties, entertainment tax etc.States also have non-tax revenues on revenue account such as interest receipts, dividends from state enterprises etc. Receipts like share of central taxes, grants in aid from Centre. State receipts also flow from loans from market and loans flowing from the Centre etc on the capital account.

States' revenue prospects are confronted with low tax buoyancies, shrinking revenue autonomy under the GST frame work and unpredictability associated with transfers of IGST and grants. Sustained efforts towards mobilizing revenue need to be combined with strategies to maximize efficiency gains rather than increases in tax rates. In this context GST architecture has to beharnessed to achieve tax revenue growth target so as to gradually reduce the dependence on compensation cess. This involves expanding the tax base using IT infrastructure, data analytics and reduction in the cost of tax compliance.

Dedicated application of break even user charges, with better cost recovery mechanism offers scope for raising states' revenue. In thisdirection, tariff policies relating to power and irrigation warrant review.States need to learn from each other's experiences to develop indigenous strategies to enhance tax buoyancy and efficiency.

To Do Activity

Students can be taken to CBDT and income tax offices

Students should be shown the income tax form and GST form

Local Receipts

India the economy of Rama Rajya and Gram Panchayats,the local Government had no devolution of funds constitutionally demarcated for it, till 1993 when 73rd and 74th Constitutional ammendments provided for federal resource transfers to local Government.This a globally rare feature of federalism evolved by India. From the state list, states may assign any of the taxes either partially or wholly to the local government. The main taxes normally assigned to local bodies (corporations and municipalities) are property taxes, octroi, terminal taxes, taxes on profession and taxes on vehicles and animals. Local fund cess (surcharge on land revenue) is the main source of revenue for district boards.In later independent era, in India, proceeds from entertainment duties are wholly assigned to local bodies, in their jurisdiction.

As this revenue flow pattern of Indian federation cedes control of state government over local government defeating the aim of decentralization of powers in a federation. 11th Finance Commission of India, allowed for direct flow of some funds from central Government to local Government.20% weightage is given to decentralization and 10% for revenue efforts of local bodies.12th Finance Commission augmented ‘consolidated funds’ of the states to supplement the resources of local bodies in the state on the basis of recommendations made by the ‘State Finance Commission’.It was compulsory for all states to appoint a State Finance Commission.

Local taxes now are in the form of Chulla Tax, Octroi, entertainment tax and tax on rented property.(property rented by semi Government or Government offices could become good and stable source of local revenue)Local bodies with 29 functions are not still having clear,significant and stable source of revenue. Internationally, Switzerland has strong local tax revenue.21.10% of local revenue flows from local taxes which should be amicable to India.

Indian Federal tax system needs changes.Tax to GDP/SDP ratio is among those with lower tax mobilizers.There is need for tax diversification and innovativeness at all levels of federation.States are growing in revenue and tax productivity.But due to due to fiscal deficit constraints market borrowing by states is increasing compared to tax efforts. Local bodies are growing in functions but tax efforts are negligible. Dependence on state devolution inhibits local autonomy.

- **To Do Activity**
- Students can be taken to Local Panchayat for interaction with office bearers about their functions, resource flow and resource adequacy.
- There can be a class discussion about possible innovative tax collection by Local Governments
- Students can be asked to read out passages from 'The Tale of Two Cities' of Charles Dickens showing the role of local Governments
- Teacher can share with the students, the vision of local funding under Rama Rajya?
- Pupils can be asked to share the vision encompassing financing under Gandhian Swarajya.
- Gandhians can be invited to interact with students about funding under Gandhian local governance.
- Experts in ancient scriptures and ancient History can be invited to share on local funding in Rama Rajya

Finance Commission

As per the provisions of Indian Constitution, the Finance Commission is appointed by the President in 1950. Under article 280 of the Constitution, Finance Commission was to be appointed within two years of initiation of the Constitution. The article also states that the President has to appoint a Finance Commission every five years or if need arises even earlier.

The function of the Finance Commission thus appointed, is to make recommendations to the President regarding the following:

1 The distribution of proceeds of the taxes between Union and States which are to be divided between them and the allocation of shares of such proceeds among the states.Principles that should govern Central Government grants in aid of revenues to the states and out of the consolidated funds of India.

2 The modification and continuance of the terms of any state under article 273 or 306 and any other matter referred by the President to Finance Commission towards sound finance.Devolution of funds, is through three channels.64% of federal transfers are through Finance Commission. The remaining proportion is through panning Commission (now NITI) grants and through ministerial transfers as grants.

So far, 15 Finance Commissions have been appointed by Government of India. 15th Finance Commission completed its report on 1/4/2020.But it submits report to the Government in November 2020.Devolution of funds was weak before 1990s.Efforts towards globalization necessitated strong state and sub state (local) bodies.*Here is a list of 15 Finance Commisions, their dates of operation and Chairman:

Table 4.3 List of 15 Finance Commissions

Number	Year of initiation	Chairman	Period of operation
1	1951	K.C.Neogi	1952-1957
2	1956	Santhanam	1957-1962
3	1960	A.K.Chanda	1962-1966
4	1964	P.V.Rajamannar	1966-1969
5	1968	Mahaveer Tyagi	1969-1974
6	1972	J.M.Shelat	1974-1979
7	1977	K.Brahmananda Reddy	1979-1984
8	1983	J.M.Shelat	1984-1989
9	1987	Y.B.Chavan	1989-1995
10	1992	N.K.P Salve	1995-2000
11	1998	A.M.Khusro	2000-2005
12	2002	C.Rangarajan	2005-2010
13	2007	Dr.Vijay.L.Kelkar	2010-2015
14	2013	Y.V.Reddy	2015-2020
15	2017	N.K.Singh	2015-2025
Source: Compiled from Finance Commission Web site			

Finance Commissions have taken path finding decisions to simplify tax structure, increase productivity of taxes and towards more powerful state finances. Decline in grants in aid, fixing criteria for devolution of funds, increase in revenue productivity of states, Decline in fiscal deficit and empowering local revenues have all been initiated by Finance Commissions of India. Finance Commissions allot funds to states on the basis of population, size of the state, degree of backwardness of the state, productivity of State's own revenues to State Domestic Product (SDP) and proportion of fiscal deficit towards 14th Finance Commission states receipts have raised.From 1990s dependence on grants in aid and loan from RBI has declined.

To Do Activity

Students can be asked to browse through Finance Commission web site and collect information about the profile of Chairman of Finance Commission, functions of Finance Commission and important statements of Finance Commission and make presentations in group

4.7.Trends in Indian Taxation

Expansion of public Expenditure in post independent era due to developmental needs and defense exigencies is even now has put Central Government of federation of India to depend on taxation for resource mobilization. Indiahas a tax system evolved for several centuries.But we are still inadequate and have to update our federal tax system both at the Centre and in the states, in the wake of globalization.

Till 2013 when FRBM (Fiscal responsibility and Budget Management) Act was passed, Central and state tax collection fell always short of public expenditure leading to fiscal deficit. States resorted to grants in

aid from Centre and depended heavily on devolution of share of Central taxes to cope up with the fiscal situation. Centre resorted to Reserve bank for deficit Financing. After FRBM, states own tax revenue has increased and fiscal restraint has also been seen in both centre and states.Dependence of states on grants in aid from 1990s is declining remarkably.

Local Government is recognized as a demarcated level of Indian federation only from the 73rd and 74th amendment of the Constitution in 1993. Local tax revenue is negligible.Local Government depends on devolution of state taxes and direct grants from Centre after the pronouncement to that effect, of 14th Finance Commission. There is still clear need for innovative and productive local taxes and non- tax revenue. When the central tax revenue is observed, it is encouraging to see the trend of increasing tax mobilization in aggregate as seen in the figure below.

Figure 4.5 Government of India Tax Revenue

It is remarkable that it has grown from Rs.210 Billion in 1985-1986 to Rs.10,888 billion in 2016-2017. Diversification of taxes and broadening of tax base innovative taxation and removal of archaic taxes have been on the time line, causing the growth of central tax revenue.

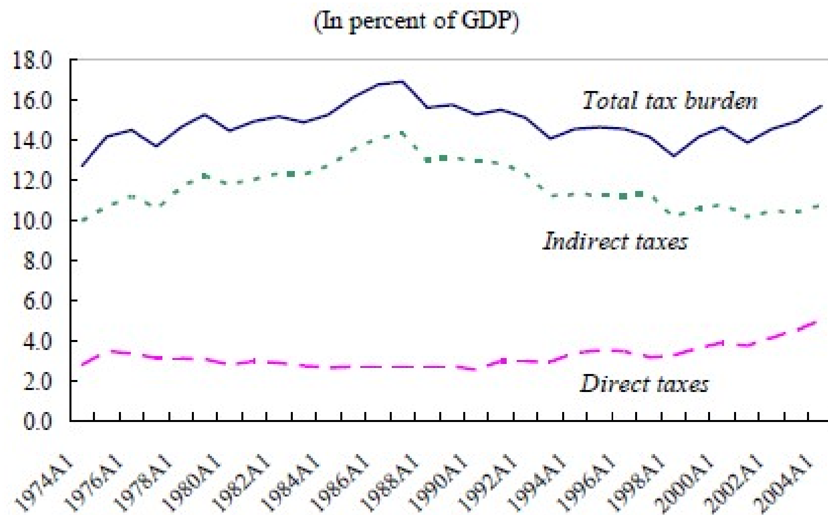

Figure 4.6 Tax Burden, 1974/75-2004/05

Source: Indian authorities; and staff projections

Total tax burden of Indian tax system is higher through indirect taxes.Indirect tax burden is on common man. Direct taxes are more progressive than commodity taxes. Over the years this trend has continued.GST is more uniformly levied on the people because the GST rates are five.But the trend of more dependence on indirect taxes for Central revenues is often deplored. The trend continues from 1990s to this day.

From 1991, there is continuous rationalization of Indian customs.Customs duty was more than 120% and multiple rates ruled before 1991. Customs was reduced to 56% in first stroke. This tax and Central Excise (now CGST).The number of tax rates wasreduced and continuous simplification of taxes is also being endeavored over the years. From 2017, GST is being implemented and is in its initial stages.This is a stupendous movement towards harmonization of Indian tax system in a globalized world.(Harmonization refers to falling in line with global practices.).This increases international trade and better Balance of Payments(BOP) of India.

Corporate taxes rates are said to be high and they are cited to be discouraging investors.The tax contributes high revenue to Central Government of India. Present Government has reduced Corporate income tax and removed dividend taxes to reduce recessionary tendencies.As seen in the figure below, State taxes bring lesser tax revenue of 37.35% to Indian federation while central taxes bring in 62.65% of the total revenue. Local revenue proportion is not even projected.It doesnot show decentralization of revenue generation in India. This shows centralization tax flows. This doesnot manifest an ideal federation. Canada for instance has 48.28% of revenue from Centre and 41.94% from the states. Germany has 48.80% from Centre and 39.10% from states.Switzerland has 48.81% from Centre and 30.30 from states.These exude federal nature of revenue and decentralized revenue mobilization.

Table 4.4Revenue (%) Decentralization in Select Economies in year 2000

Revenue (%) Decentralization in Select Economies in year 2000			
Country	Centre	State	Local
Australia	77.68	19.26	3.07
Austria	70.92	11.49	17.68
Belgium	90.01	3.82	6.17
Bolivia	76.55	3.75	19.70
Canada	48.28	41.94	09.78
Columbia	83.41	5.58	11.12
Germany	48.80	39.10	12.10
India	62.65	37.35	NA
Mexico	75.63	19.02	5.37
South Africa	92.26	0.70	7.04
Spain	73.47	12.12	14.41
Switzerland	48.81	30.30	11.58
USA	69.27	19.15	11.5
Source: Biju, 2008			

India has brought in innovative efforts in the arena of Union taxes after 1991, like presumption tax on small unorganized businesses, Minimum Alternative Tax on zero tax Companies, Value Added Tax (VAT) on every point of addition of value during the production of a Commodity and finally GST in its three components on all goods and services.Still 'flawless GST' has to evolve. Income tax exemption limits were raised to make it more progressive. Current Government has stepped up income tax raids and demonetization to act on 'willful defaulters' and through that increase productivity of income tax.

To Do Activity

Students can be asked to read out the percentages of Central, State and Local proportion of revenue in all countries in the list and compare

Students can be asked to enlist the new taxes introduced after independence

Students can be asked if to tell if they and their family pays taxes and ask them to list when they pay a tax.

Ask students if they are proud or angry to pay taxes and why?

Chapter Summary

Evolution of federalism in India is traced back to later pre-independence era. It is a combination of British fiscal system and American form of federalism. The taxes of central Government are given in the Union List. Here are taxes that accrue to Union exchequer. They are used towards the functions of the Central Government.Some union taxes are shared ass federal transfers with the states.Regional Governments which have flow of revenue receipts and allotments from the Union Government. They are notified under State List. These receipts flow as demarcated by the Constitutional body of Finance Commission which is annually appointed by the President of India and reports to the president. The flow of funds through the Union Government as allotted by the Finance Commission to the states is termed as 'devolution of funds'. They are also referred to, as federal transfers. The receipts of the state Governments are used towards the federal functions of the states.They are also used to implement Central Government schemes and international programs. So far there have been 15 Finance Commissions after independence. Along with Planning Commission, Finance Commissions have brought in several changes in economic growth and distribution of income in the states of India. They (Finance Commissions) have also pronounced important changes in fiscal policy of Central Government can also resort to support from the Reserve Bank of India, borrow from the market and international organizations.

State Governments also can borrow from the money market and resort to loans from the market apart from the devolution of funds. State Governments can also seek grants and loans from international organizations with the permission of the Government. State Governments can seek the financial assistance of concerned Union Ministries for implementation of Central Government schemes by the states. Ultimately, Indian federation is a threetier structure constituted by Central Government, State Government and local Government.But the flow of funds to local Government from the Centre is only through the states. Self -generation of funds of local Governments is limited. So the third tier largely depends on the state Government even in expenditure of receipts. Even states largely depended on grants in aid from the Centre in early decades after independence. Now there are many autonomous aspects of functioning of states due to greater revenue generation through state taxes. States own taxes are high in proportion in developed states leading to greater independence in functioning. However, cohesive functioning of the central Government and the state Governments is the crux of Indian welfare economy.Local Finance as the third tier of federalism was constitutionally approved in 1993, as per 73rd and 74th amendment of the Constitution. Local Taxation is still insignificant and inadequate as a source of federal finance of India. Demonetization and income tax raids are acting on willful defaulters (the entities who knowingly avoid taxes).Thus federal taxation is an interest intellectual engagement with scope for innovativeness and movement towards improvement of tax structure towards international standards at the same time meeting local needs (emulating international fraternity like Switzerland, Germany and Canada).

Model Questions

1. Briefly state the evolution of Federal tax System in India.
2. What is the significance of Act of 1935 in Indian federalism.
3. Name the taxes in Union List
4. Name the taxes in State List
5. Name the taxes collected by Local Government (2 marks)
6. Which strata of Indian Federal tax system is still emerging and why?
7. State the significance of 73rd and 74th amendments of Indian Constitution in Indian federal tax system
8. Give an account of the structure of Finance Commission? How many Finance Commissions have been appointed till 2020?
9. What are federal transfers.State the forms of federal transfers.
10. Which are states own taxes?
11. Why is local Government not emerging as an autonomous level of federal taxation?
12. What are the functions of Finance Commission?
13. Mention the three channels through which devolution of funds to states happens in federal finance.
14. Critically examine the issues in federal taxation in India
15. Write a note on Income Tax, Corporation Tax, Service Tax, Sales Tax, Customs Duty, Octroi, CGST, SGST, and IGST
16. Give an account of how GST is computed ?
17. Mention GST components
18. Mention the areas impacted By GST
19. Mention the rates of GST
20. Who is a 'taxable person' for GST?
21. Mention and define any five innovative tax efforts in Indian federation after 1991.
22. Mention any 5 positive changes in Indian federal taxation in this decade

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Chapter 5 Professionals and Businesses

Introduction

Significant proportion of national income and employment in the globe is held by businesses and professions constituting individuals and households. Understanding the concepts in the process and way they are taxed provides strong grounding in working with economic entities that impact changes in percapita income at grass root levels of rural economy. In commercialized economy it is often found that rural population is in need of information and knowledge about the meaning and difference between business and professions. They also require sensitization how businesses and professions are taxed and how they can claim deductions and exemptions as businesses and professions.Such understanding will take learners much ahead in economic engagements. Globalization has led to several positive externalities of environment with the increased participation of nations and corporate. There has been huge growth of national income of economies with international businesses providing more scope to tax businesses and professions involved. Study of the connected trends here throws light on the resultant boundaries of taxation. The need to add to national income of economies by levying environmental taxes has been discussed often. Panoramic view of this new aspect tried to be given here will trigger interest in new horizons of taxation in international trade.

Objectives

- To explain the meaning of widely used concepts of Business and Professions
- To train on what basis the ‘process of chargeability of income’ in these heads under income tax act happens
- To enable confidence about allowable and disallowable expenditure of businesses and professions during taxation
- To provide basic understandings of Corporate Taxes and retained earnings
- To give basic understanding of the changes in national income and international trade as related to taxation

Chapter Structure

5.1 Business and Professions

5.2 Chargeable Income under Each Head

5.3 Allowable and Disallowable Expenditure

5.4 Corporate Taxed and Retained Earnings

5.5 Trends in National Income, International Trade and Taxation

5.1. Business and Professions

Meaning

The term Business as related to taxation does not essentially mean that a business is being carried on permanently (continuity) or that there should be a series of transactions in a business (repetition).In this context,' Business' just means an economic activity carried on with profit motive. According to section 2(3) the term means 'Any trade; Commerce, manufacturing activity or any adventure or concern in the nature of trade, commerce and manufacturing.

There are two types of business: speculative and non- speculative.

Speculative business income includes income from intraday equity trading. It refers to buying and selling of financial instruments on the same day. The net amount from it is not fixed and could change from time to time. Share trading is a case in this context.

Non-speculative business income includes income from trading futures and options (F&O). F&O is also considered as a non-speculative business. This non speculative instrument is used for hedging and for taking and giving delivery of underlying contract. In other words, the amount of profits /loss is fixed and does not change for a period of time. Example: any manufacturing/trading or any business.

Profession is defined as a service or a job based on some thought, skill sets or special knowledge like for instance that of a lawyer, Doctor, Engineer Economist etc. Therefore, profession means those activities where in salary is earnt through intellectual or manual skills.Vocation constitutes both business and profession. It covers all facets of an occupation carried on by a person with an aim of earning profits.

As per section 2(36), profession includes vocation. As profits and gains of a business, profession or vacation are chargeable to tax under the head 'profits and gains of business or profession', the distinction between 'business', 'profession' and 'vocation' does not have any material significance while computing taxable income. What does not amount to 'profession, may amount to' business' and what does not amount to 'business' ma amount to 'vacation'.

5.2. Income Chargeable under each Head

Under the heads profits and gains of business or profession**,** the income shown below is chargeable to income tax under the head 'Profits and gains of business or profession':

i. The profits and gains of any business or profession carried out by the assessee at any time during the previous year.

ii. Compensation or other payment due to or received by – any person by whatever name called, managing the whole or substantially the whole of the affairs of an Indian company at or in connection with the termination of his management or the modification of the terms and conditions relating there to;

iii. Income derived by a trade professional or similar association from specific services performed for its members;

iv. The value of any perquisite or benefit arising from business or profession, whether convertible into money or not;

v. Any interest, commission, salary, remuneration or bonus due to or received by a partner of a firm from such firm

vi. Any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy.

vii. Income from speculative transactions.

viii. Any sum whether received or receivable, in cash or kind or an agreement for not carrying out any activity in relation to any business ornot sharing any know how, patent, copy right, trade mark, license, franchise or any other business or commercial right of similar nature

ix. Any profit on the transfer of the duty free replenishment certificate

x. Any profit on the transfer of the Duty Entitlement Pass Book Scheme

xi. Profits on sale of a license granted under the imports (control) Order , 1955, made under imports and exports (control) order, 1955, made under the imports and exports (control) Act 1947 (18 of 1947)

Business Income not Chargeable under the Head 'Profits and Gains of Business or Professions'

Under section 28following cases of income from trading or business is not chargeable under the head 'Profits and gains of Business or Professions'**.**

Table 5.1 Cases of Business or trade not Chargeable under the Head Profits and gains of business or professions

	Nature of Income	**Head under which it is chargeable to tax**
1	Rental income in the case of dealer in property	Rent of House property is taxable under section 22 under the head 'income from house property' even if property constitutes stock in trade of recipients of rent or the recipient of rent is engaged in re business of letting properties on rent.
2	Dividend on shares in the case of dealers in shares	Under section 56(2)(i) dividend on shares are taxable under the head 'income from other sources', even if they are derived from shares held sd stock in trade or the recipient of dividends is a dealer in shares. However the dividend received from an Indian Company is not chargeable to tax in the hands of shareholders.
3	Winning from lotteries etc	Under the Head 'income from other sources', winning from Lotteries, races, etc are taxable , even if derived as a regular business activity

5.3. Allowable and Disallowable Expenditure

Allowable expenses are those non -taxable essential business costs. These expenses relate directly or indirectly to generating income in the business. Allowable expenses are incurred on business in the current year. These allowable expenses are not accounted as part of the Company's taxable profit. So taxes need not be paid on these expenses. Tax deduction is claimed for them. Most of the small businesses claim deductions for allowable expenses with some exceptions. You cannot claim allowable expense if you have tax free 'trading allowance'. Small businesses have to distinguish often between personal and business expenditure. Under the situation, only business costs can be included allowable expenditure. Allowable expenditure are always revenue expenditure such as repair, maintenance and renovation. As connected to taxation, what is allowable expenditure depends on the tax laws of a country.

For example, if one has a business revenue of Rs. 90, 000. Out of that, disallowable Business Expenses are Rs.10000 and allowable expense are Rs.5000.Then, income subject to tax will be 90,000-5000=85000.

While computing profits as well as gains from business or profession, as listed in section 30 to 36 certain deductions are allowed given certain conditions stated in the sections. However, the section does not give all types of expenses. For the types of expenses which are not mentioned between section 30 to 36 deduction can be claimed as per section 37 of income tax act. So, section 37 is called as the residuary section for claiming deductions. Section 37 was amended in 1998 to specify a disallowance.

There are some general conditions to claim allowable Expenses such as the following:

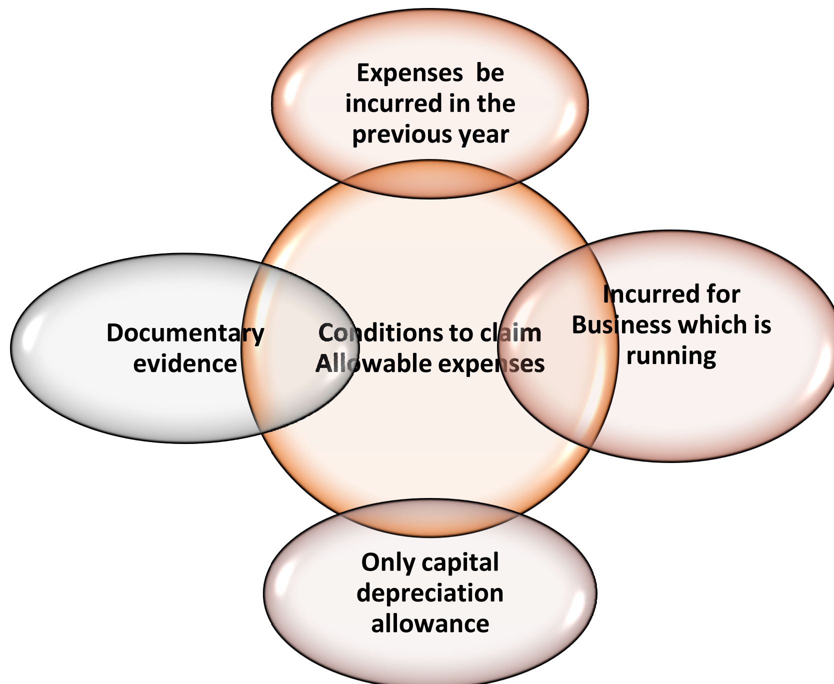

Figure 5.1 Allowable expenses

Expenditures incurred and paid during the year are without doubt allowable expenses. But there are expenses incurred but not paid and in some cases provisions are made by way of accrual method consistently adopted by the assessee. Law states expenses which are not contingent upon happening or non -happening of future event are allowable. Expenditure has to be incurred. It is incurred when the legal liability to pay has arisen. Actual date of monetary payment does not matter.

The purpose of incurring expenditure must be one's business. It should be evident that there was need to spend the money to earn income. Expenses that are private and personal by nature are not considered to be related to business and therefore are not allowable. There should be documentary evidence of the concerned expenses. Such documents should be kept for at least five years to substantiate one's claims.

Capital expenditure is not allowable under business expenditure. Example: fixed assets such as plant and machinery. But depreciation of fixed assets may be claimed as capital allowances. Separate rules apply to limited Companies.

Allowable Expense

While computation of profits and gains from business or profession, income tax department does not allow deduction or benefit of tax deduction on such expenditure. Assesses are bound to pay taxes on such expenditures by adding it back to their net profits. Such items are called disallowed expenditure of business and profession. Capital expenditure is always disallowable expenditure. They are disallowed under income tax act because they are not incurred completely and exclusively to generate business income. For instance, asset improvement expenditure or enhancement expenditure is an example. Personal expenses are disallowable expenditure while calculating allowable business expenditure. All expenses incurred during the previous financial year in the current financial year are disallowable expenses for tax deduction. Example: Personal expenditure of the director or an employee. All payments on which specific amounts have to be deducted and deposited to the Government and the same is not deducted or is unpaid are disallowed. But at a later stage allowance for the expenditure can be taken when the amount is deducted or deposited.Some of the allowable expenses are provided below:

- Subscription to Professional bodies and associations
- Contribution to pension schemes
- Travel allowances
- Mileage allowances
- Expenses of employees towards their employment
- Capital allowances on plant and machinery.
- Present liability and future liability`
- Leave encashment
- Freebies to Medical practitioners
- Keyman insurance policy
- ROC (return On Capital) fee to increase authorized share capital to issue bonus shares (are revenue expenditure)

- Interest on delayed payments to small scale and ancillary industrial undertakings
- Contribution to State Government
- Expense of an assessee on tax payment in a foreign country is allowable expense for deduction as per u/s 37(1) of Income tax Act-ITAT.

To Do Activity

Students can be divided into two groups with one group mentioning one Business or Professional expense and asking the other group if it is allowable or disallowable expense, with right answer carrying points.

Disallowable Expenses

Section 40 of income tax Act states some expenses which cannot be allowed for deduction under income tax computation. Before Finance Act of 2013, the list of such 'disallowable' is as below:

- All expenses mentioned between section 30- section 36 of income tax Act
- All expenses which are personal in nature
- All expenses which are of capital nature
- All expenses which come under 'Corporate Social Responsibility'
- Foreign travel of relatives of Director or foreign travel of the Director not for business purpose.
- Expenses incurred by the assessee on advertisement in any souvenir, brochure, pamphlet, track or similar publishing by a political party.
- Interest, royalty, fees chargeable for technical and other services payable outside India, or to a foreign Company in India or Non Resident Indian Company
- Payment to a provident fund or any other fund for the benefit of an employee
- Salary, bonus, Commission or any other remuneration to a non-working partner
- Remuneration to any partner who is of interest to any partner but not in accordance with the business deed or not during the period of the business deed.

Expense incurred on an offensive activity or which is prohibited by law is not allowable for income tax deduction. Section 37 of income tax Act was amended in 1998 to mention that expense off an assessee for any offensive purpose prohibited by law. Section 40 of Indian income tax Act was amended to provide that any amount paid fee, charge etc which is levied exclusively on or any amount appropriated, directly or indirectly from state government undertaking , by the state Government shall not be allowed as deduction for the purpose of computation of income of such undertakings under the head – profits and gains of business or professions, to protect the tax base of state Government undertakings through

special levy of fee, charge etc or appropriation of amount by the state Governments from it undertakings.

Finance Act of 2013 added another category of 'disallowable'. It states that any amount paid as royalty, service fee, fee, license, privilege fee, service charge or any other charge levied exclusively on appropriate directly or indirectly on any state Government undertaking is not eligible for deduction in income tax computation. When the allowables and disallowables are observed, it is visible that they are given for various economic, social reasons. If these allowables are discontinued, without considering the logic behind granting them, the system is destructed.

To Do Activities

Class can be asked to find out from Businesses they know, what deductions they claim and what are disallowables for their business.

Class can be asked if the allowables are fair as per the Constitution of India.

5.4. Corporate Taxes & Retained Earnings

It is interesting to understand how Corporate taxation impacts Indian economy, with India in need of growth propelled by Corporate Businesses than ever before. It is often said corporate taxes discourage investment with the rates being high. It is also said that corporate taxation reduces retained earnings.
Finance Act which prescribes the rates of taxes by the categories of assesses, for the purpose of levyingIncome tax and corporation tax into (a) individuals, (b) Hindu Undivided families (HUF), (c) unregistered firms, (d) Association of persons, (e) Registered firms and (f) Companies. The totality of income tax collected cover income tax, super tax, surcharge (union), additional surcharge (union), surcharge special, excess profits tax, business profits tax, advance payments of tax etc levied on income (other than agricultural income) of the assessee shown under (a) and (e) above. Corporation tax is connected to income tax, super tax, excess profits tax, business profits tax, super profits tax, advance payments tax sur tax etc levied on income of companies from all sources.Net of all refunds makes the totality of collections. In the finance Act a company is defined as registered under Indian Companies Act or any Indian or non- Indian Association whether incorporated or not as declared by Central Board of Revenue(CBR) as a Company for the purposes of the act. A Company's source of income are (i) interest on securities, (ii) income from property, (iii) profits and gains from business (iv), income from other sources and (v) capital gains. Out of these for tax purposes, most important is profits and gains from business. In any financial year, on income earned previous year income tax, super tax etc are levied.

Number of factors determines total collection of income tax or corporation tax in a given year like tax rates, distribution of income into institutional sector. Income tax and corporation tax collection in a particular year do not necessarily relate to income of that year. Significant portion of the collections pertain to the income of previous year. Arrears of the past recovered and refunds of excess tax collection in the past. This makes lagged relationship with other income tax components important.

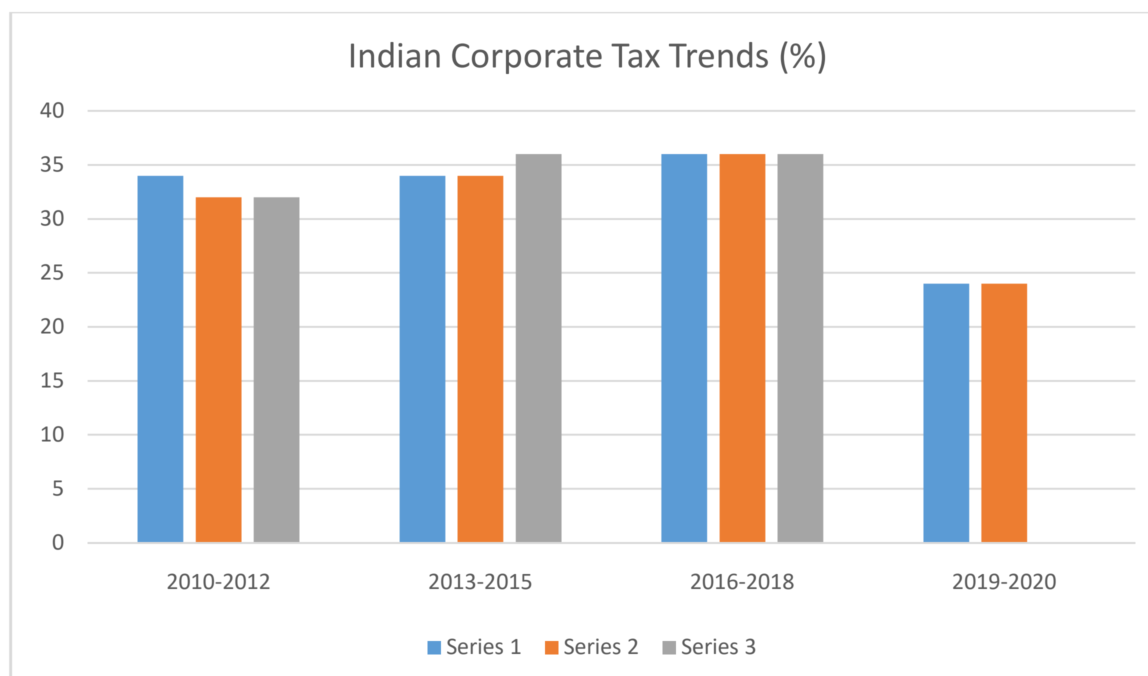

Figure 5.2 Trends of Indian Corporate Tax Trends

Source: trading Economics.com

Corporate tax rate in India remained above 34% and was often subject to criticisms by the corporate for causing low retained earnings till 2019-20.Now the effective corporate taxes for Indian domestic companies is at 25.17%including all surcharges and cess related to these domestic companies. On September 2020, Finance Ministry of Government of India announced a significant cut in corporate tax rate 22% applicable from the financial year that began 1st April 2020 (including cess and surcharge it is 24%.In this year's budget, dividend distribution tax (DDT) is removed). (As already mentioned corporate tax revenue is second highest for Indian Union Government next only to income tax.)

Stable and sustainable national and sectoral growth hinges on own savings of economic entities. The best source of financing investment of a company, in terms of risk and cost is retained earnings. So retained earnings are a precious source of finance theoretically. But the reserves and surplus of a company have not been claiming the first priority in the 'pecking order' of Companies to finance investment in India like in many other economies and as per theoretical perception. Furthermore, the extent of retained earnings depends on the amount of profits after tax, investment opportunities, external funds available, borrowing cost, dividend policy and share holding pattern in an economy.

Changes in corporate tax have powerful dynamic effects of a consistent with being essentially source based tax. Consistent with the notion that In the short run, increased corporate taxation is associated with increased net exports consistent with the notion that such an increase leads capital to flow abroad. This increase turns into a persistent reduction in net exports. However, consistent with the increased inflow of income from abroad associated with the initial outflow. Over the long run however, the effect declines to zero leaving net exports unaffected. Some aspects of domestic tax policy have strong effects

on trade policy and they can be quite complex. Under recession, decrease in corporate tax encourages home investors to run corporate businesses to reap profits expecting greater retained earnings as corporate tax ix low. Current budget has decrease in corporate tax after a long time, to 22% and removal of DDT could lead to this outcome.

Retained earnings are defined as that part of corporate profits that remain after payment of taxes which are not distributed as dividends to the shareholders of the Company**.** This amount is the residue that remains with the Company normally ploughed back (reinvested in business) next year. Therefore they are also called Corporate Savings and are synonymous to Corporate plough back profits.

Retained Earnings= Post tax Corporate Profits –Corporate Dividends

Annual Report of concerned Company includes retained earnings in yearend balance and changes in balance through the time line of the year. Countries have different practices about retained earnings. In India it is said corporate taxes are high as to reduce retained earnings. This year's budget has encouraged distributing dividends by removing tax on dividends. In USA, corporations cannot retain earnings just for tax avoidance. Domestic companies which accumulate their earnings (profits) instead of distributing them as dividends, are subject o 'accumulated earnings tax, if the amount of accumulated earnings exceeds $250000 by Internal Revenue Service of federal Government of USA. The accumulated earnings tax rate is 20% of accumulated earnings. In USA such companies are considered to be precious by the Government.Companies for the purpose of Corporate taxation are of the following three types.

Figure 5. 4 Types of Companies for Corporate Taxation

Trends in retained earnings of Public Limited Companies (PUL Cos), private Limited Companies (PRL Cos) and Foreign Companies (FRCos) in India corporate earnings in India have not increased significantly and have remained low.

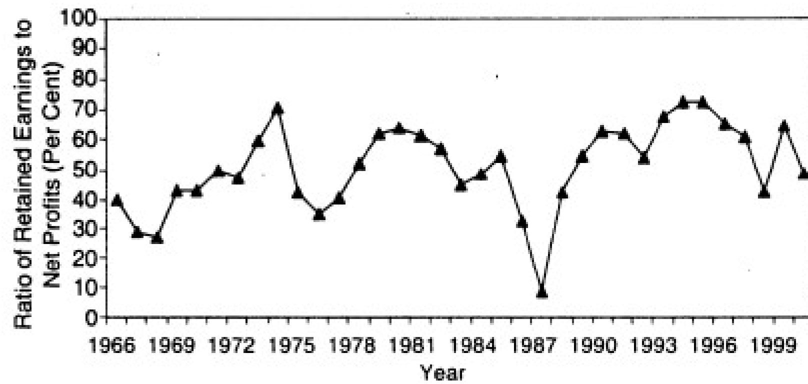

Figure 5. 5 Percentages of Retained Earnings to Net Profits of PULCos

Source: Computed from Reserve Bank of India Company Finance Studies

In the above graph (Fig 4) retained earnings of Public Limited Companies is seen around the level of 1961 at 40% in year 2000.There is no significant upsurge over time. The causes cannot be clearly stated due to non-synchronized data of factors influencing retained earnings.

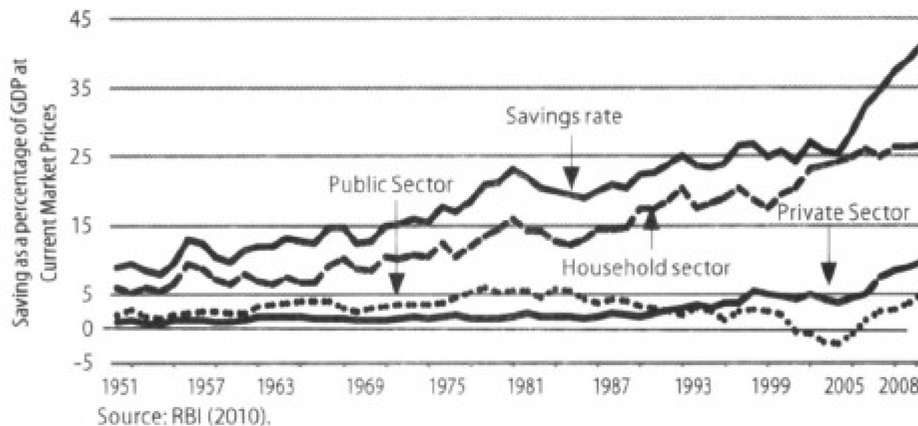

Figure 5.6 Trends in Domestic Saving Rate

In the graph (Figure 5.5) public sector and private sector savings at market rate shows corporate public sector savings is stable around 5% and private sector savings slightly better at around 10%.Out of this corporate savings (public sector+ private sector) has remained a stable low though total savings rate is increasing and is nearing 45%. Retained earnings are a portion of the corporate savings after distribution of dividends.

Table 5.2: Corporate Financial Performance: Select Growth Rates (in %)

	Sales	Expenditure	Depreciation Provision	Gross Profits	Interest Payments	Profits after Tax
1991-92	19.0	19.2	18.2	22.2	28.7	6.5
1992-93	12.1	14.5	16.3	3.7	21.6	-5.1
1993-94	15.4	10.3	-2.6	22.5	3.1	68.6
1994-95	20.5	20.7	15.9	31.7	8.1	59.2
1995-96	23.7	24.0	23.3	31.0	25.0	23.9
1996-97	10.4	11.4	28.6	-1.9	25.7	-26.6
1997-98	7.5	10.6	25.6	-2.8	12.5	-13.7
1998-99	6.1	6.7	14.4	-3.2	11.1	-20.9
1999-00	11.2	11.9	15.8	9.0	6.7	14.7
2000-01	9.9	9.6	7.1	5.8	7.1	8.3
2001-02	-1.3	-3.3	9.6	3.0	-5.1	-17.8
2002-03	8.5	8.7	4.9	9.8	-9.8	76.2
2003-04	16.0	13.2	6.0	25.0	-11.9	59.8
2004-05	24.1	21.9	11.2	32.5	-5.8	51.2
2005-06	17.9	18.1	11.6	20.5	1.7	28.2
2006-07	26.5	24.4	17.2	44.7	24.9	44.0
2007-08	18.6	19.6	15.7	24.9	29.4	26.0

Source: RBI, various years.

To Do Activity

Students can be asked to collect annual reports of Companies and search out corporate tax data and corporate retained earnings data in the balance sheet.

5.5. Trends in National Income, International Trade and Taxation

In the present world, all economies are 'open economies'. There is no closed economy without international trade. All goods and services used in the home market have international element in them. One or more inputs are from rest of the world. Innumerable products that consumers and producers use are imported and exported. There are several perceptions of national income. When national income is seen without external sector, it is Gross Domestic Product (GDP) including international trade component, national income is defined as "the sum total of goods and services produced within an economy per year, including of course the income from abroad" which is Gross National Product. GNP=GDP+ (X-M) or GNP= C+I+G+ (X-M) because GDP= consumption (C) + Investment (I) + Government Expenditure (G) where X is exports and M is imports.

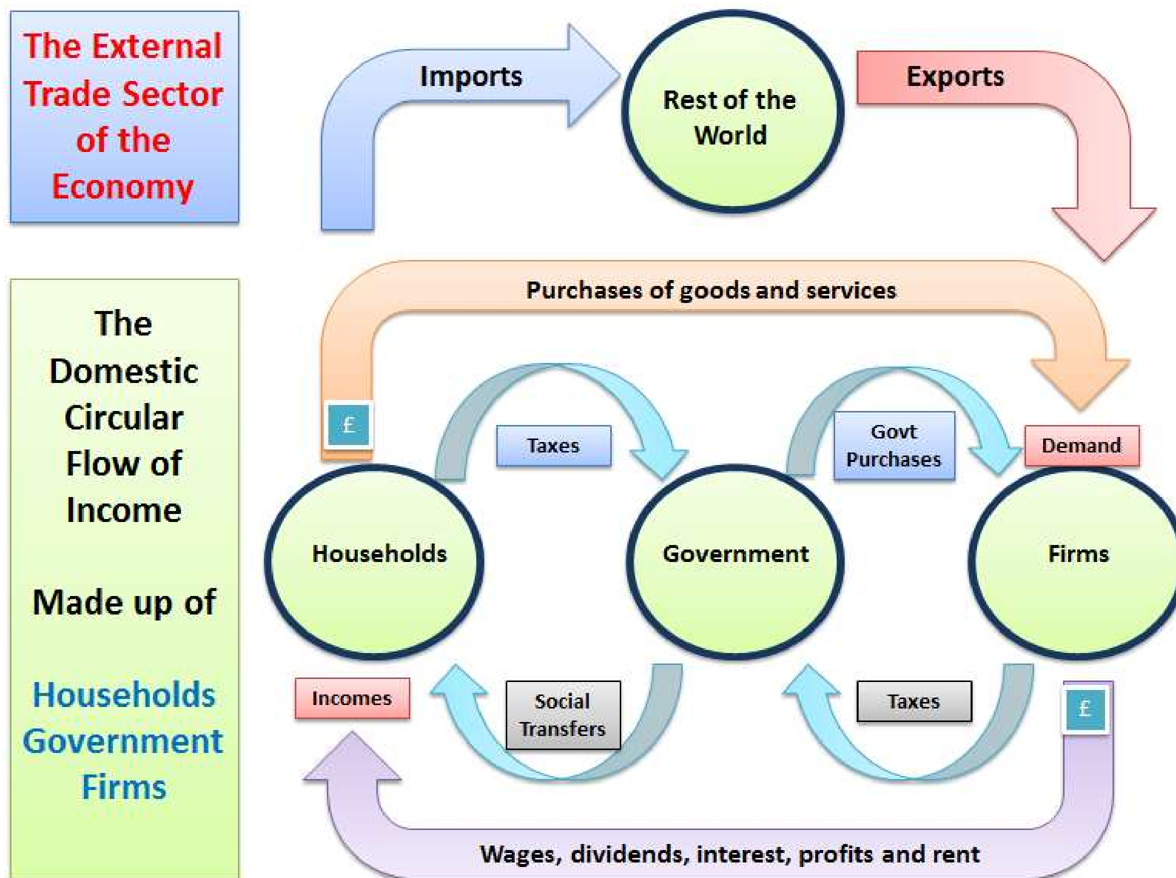

Figure 5.7 Circular Flow of Income with International Trade (External Sector)

Applied from section 16.16 Andy Schmitz 'Theory and Applications of Macro Economics' 2012 Publisher: Creative Commons

In the above graph basic producers (supply) and consumers (demand) are firms and house holds. Firms produce goods which are consumed by households. Households produce services for firms in the process of production. Firms demand the services of households and income is distributed to households (wages, dividends, interest, profits and rent) by firms. Households demand the goods produced by firms with the income they secure providing factor services (inputs) to firms by paying 'price' for the goods produced by firms where by firms get profits. Thus basic circular flow of income happens in a market economy. Government is a not a producer.

But intervenes between households and firms and provides households and firms administration and security for which firms and households pay taxes. Expansion of market has led to supply and demand for goods among economies of the world.

International trade is generally viewed as an engine of growth. It helps developing economies to accumulate high quality capital, update technology and technical knowhow, create more employment, increase economic growth and globalize economies.There are several factors affecting the relationship between GNP and international trade. The relationship between the two concepts is complex. The

annual record of exports and imports according to double entry book keeping method, Balance of Payments (BOP) figures in GNP. If BOP has exports more than imports, GNP increases. If imports are higher than exports, GNP decreases. Thus international trade influences GNP. Internal prices of labour and resources decide product prices. These prices relate to international price of products.

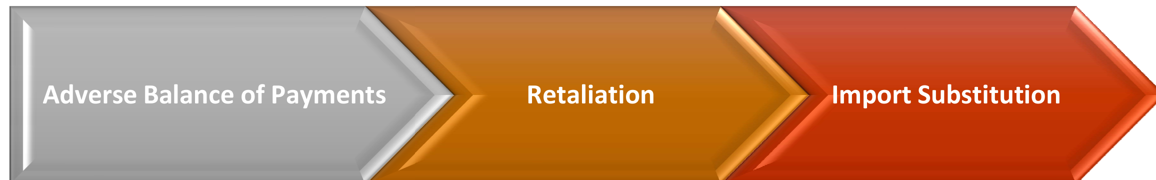

Figure 5. 8General effects of Customs Duty

In a quazi - protected world of international trade, tariff (customs are export duty and import duty) adds to the cost of production to increase international price of the product. Therefore, import duty is more common than export duty. Tariffs are among the oldest barriers on trade. When export price is high demand for the product, declines reducing national income. Import duty leads to restriction of imports and nurtures import substitution.

There will be growth of industries producing substitutes to the hitherto imported product. When import prices are high also, GNP declines in the short run. High import value results in adverse balance of payments. This affects GNP of the economy and economic growth of the concerned economy declines. In In Indian economy, this situation was prevalent and was one of the causes of economic crisis of 1990. So also, Indian customs duty was more than 150% before 1991 on several products which made adverse balance of payments (X>M) an endemic feature of Indian Economic growth. After 1991, drastic decrease in Customs duty rates (30% by 2002) led to improvement in Balance of payments. IT exports shot up towards favourable balance of payments. This further led to increase in GNP and positive economic growth.

In India, import price of crude which has inelastic demand, is high. This reduced our GNP all decades after Indian independence. When GNP decreases over time, we have low economic growth. In the long run import duty leads to import substitution. In case of crude, India encouraged renewable energy like thermal electricity, bio diesel, and solar energy. Due to such import substituting enterprises, home industries grow and employment is generated to prop up percapita income and thus GNP increases and economy grows (Economic growth=↑GNP overtime).

Effects of Tariffs as per Theory of Tariffs

In the diagram below OX which is X axis shows supply and demand. OY the vertical Y axis indicates price. Upward sloping line SS shows supply and downward sloping line DD shows demand. SS and DD intersect at Z. Before levying tariff supply is at OL. Demand is at OQ. OB is the price on Y axis. At this point demand (OQ) exceeds supply (OL).Excess demand is met with import LQ. So the tariff paid is BC for this import. As a result price increases to C from B. As at OB price imports have infinitely elastic demand, the tariff affects price and it rises to OC. At OC price, foreign supply line shifts to CWW. As a result, Imports are cut to MP from LQ. Home production increases from OL to OM.

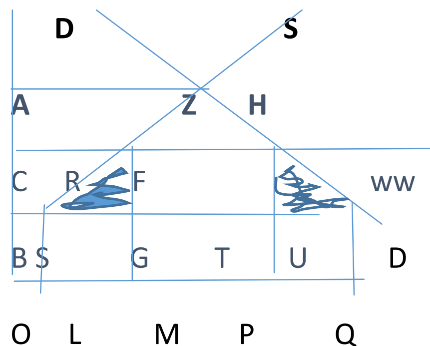

Figure 5. 8 Theory of Tariffs

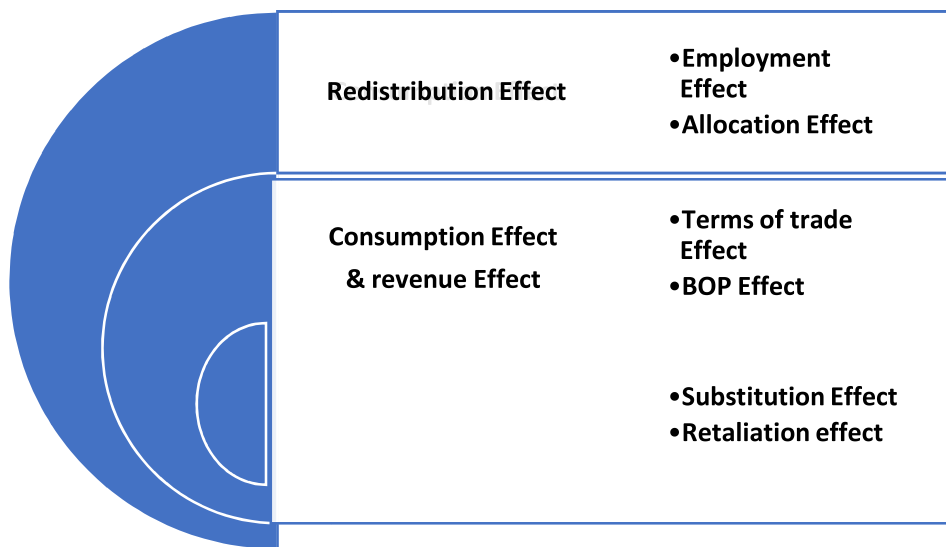

Figure 5.9 Effects of Tariff

Tariff is a relevant fiscal instrument of commercial policy in international trade. Though it is a protectionist policy, it is a double edged weapon. In one direction, it forces consumers to buy their preferred product at a higher price (consumption effect). On the other, it shifts the use of resources in the home economy away from one use to another. Imports decline and home Producers of substitute product are encouraged to enhance production which is protection effect.

The Relative Price of Products Change
Relative price of factors of production also change with import substitution. Therefore, allocation of resources changes. This redistributes income in the economy in a different way. This is redistribution effect. Government gets income from tariffs which is revenue effect. Redistribution effect can be explained as given n Stopler-Samnuelson theorem. This theorem states that given two factors labour and capital, when tariff is imposed, the price of imported good rises. So producers change their production pattern towards increasing production of imported good and decrease the exported good production. Such a change in production pattern will influence factor prices.

Imposition of tariff increases price of imported commodity. This results in demand of consumers for home produced substitutes. To meet this new demand home producers invest more and more employment is generated. National income increases as the effect of levy of import duty. Optimum tariffs that an economy imposes depend upon that combination of effects which increases GNP.

Increase in customs leads to rise in price of imported goods. In Balance Of Payments (BOP) which is annual record of exports and imports of an economy per year according to double entry book keeping method, will be having excess value of imports compared to export value. This is adverse balance of payments. Exchange rate the rate at which one unit of a currency is exchanged for another currency, of an economy with adverse BOP will be low. Such a currency is said to be a weak currency. This will lead to decline in GNP in the short run. But a weak currency encourages exports as the price of exports in international market tends to be low. This increases demand for home goods in international market. Eventually, such domestic exports increase. Consequently in the long run home economy will experience favorable balance of payments. Indian economy reduced taxes on IT exports after 1991.This led to stupendous boost to the industry in the global market and exporters brought back the a big portion of their gains into India which increased GNP. In the home market import substituting by consumers will encourage home producers to invest in new products. In international trade, high exchange rate economies (MDCS: Most Developed Economies) levy high tariff barriers.

Indian Customs Duty
When goods are transported across the international borders, the tax that is imposed is customs duty. This tax in India is defined as per the customs Act of 1962 which empowers the Government to impose the duty on exports and imports. All matters connected to Customs come under Central Board of Excise and Customs (CBEC).The amount paid as Customs are determined by many factors like value, weight, dimensions etc of the concerned item. Indian Customs on agricultural products are said to be among the highest in the world. Customs of India are often criticized to be very complex in structure and difficult to understand and rationalize.

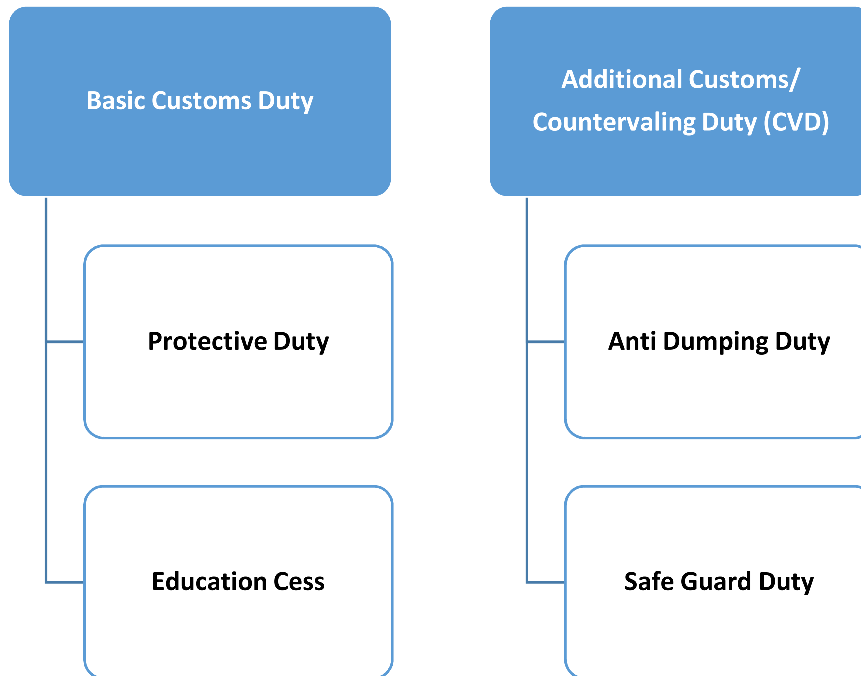

Figure 5.10 Types of Customs Duty

Customs Duties in India are classified into Basic Customs Duty, Additional Customs Duty/ Countervailing Duty, Protective Duty, Anti-Dumping duty , Safe Guard Duty and Education Cess on Customs Duty.

1 **Basic Customs Duty**: Under section 12 of Customs Act of 1962, this customs s levied at the rates stated in first schedule of Customs Act of 1975 as per the terms specified in section 2 of the Act. It is levied at standard or preferential rates depending on which country it is levied on.

a. **Protective Customs**: It is imposed to extend protection to domestic industry from imports and the rate is recommended by Tariff Commissioner.

b. **Education Cess on Customs:** This Cess is 2% and higher Education Cess and another 1% of aggregate Customs Duty.

2 **Additional Customs Duty (Countervailing Duty {CVD}):**As per Section 3 of Customs Tariff Act of 1975, this duty is levied and is equal to GST levied on similar goods produced by domestic industry in India. The rate is based on aggregate value of the good including landing charges.

a. Anti Dumping Duty: Foreign economies tend to subsidize their low quality or excess raw material or product and sell it at a price below home -produced substitute. This is called dumping. To prevent this, anti -dumping duty was initiated as per the act of 1975.For instance Chinese copper scrap sold at lower than Indian prices. Foreign wooden toys sold below Indian wooden toy prices. Japanese cars sold in Detroit below American price of its substitute. Government tends to levy anti-dumping duty on such commodities.

b. **Safe Guard Duty**: In case of expectation of the Government that a sudden rise in export tends to damage domestic industry, this duty is levied.

Customs is now paid online mostly by accessing ICE GATE e-payment portal. E-Sanchit represents e-storage and computerized dealing of indirect tax documents launched by Central Board of Indirect Taxes. It facilitates international trade by enabling customs connected online documentation. Budget 2020 has increased Customs on 50 items in order to garner more revenue from international trade in 2020-2021 to 10.4% from 6.1% in 2019-2020.

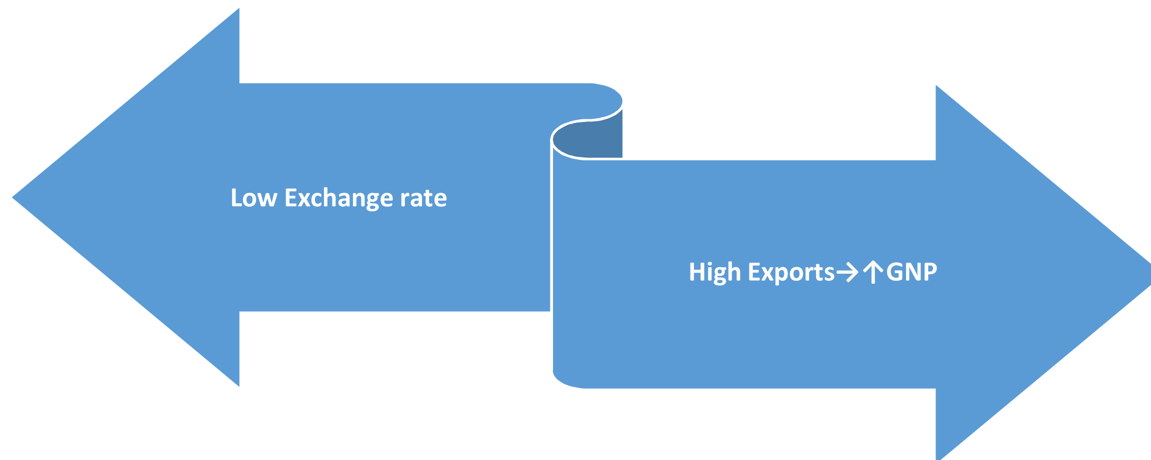

Figure 5.9 Exchange Rate & GNP

Exchange rate of an economy refers to how many units of foreign currency are exchanged to one unit of home currency. If more units of home currency are exchanged to one unit of foreign currency, hoe currency is said to be a weak currency and the home exchange rate is low. A weak currency encourages more exports as home goods tend to be cheap in foreign countries. A strong currency which means the exchange rate of home currency is high discourages exports and encourages more imports. This leads to rise in price of home goods which compete with foreign goods. If imports are of capital in nature, they increase production of concerned good at lower prices than of home substitutes. Consumer satisfaction is therefore high. High demand for exports leads to BOP surplus and also to rise in GNP.

Economies deliberately reduce the value of their currency in terms of foreign currency due to the advantages that follow. This is called devaluation. In a country with low exchange rate, if tax rates are high, there will be inflation. If there is rise in domestic price of a good, to an equal extent as devaluation or more than that people tend to import such a commodity. Thus imports will rise as much as exports neutralizing the surplus BOP due to devaluation which leads to higher national income. In the long run, this inflation leads to rise in international price of goods and reduction in demand for exports.

Multinational Companies have their subsidiaries in low effective tax rates economies like Ireland, Singapore and tax havens (countries where there is no tax on real estate and other asset transactions and where banks do not reveal details of bank accounts foreign investors) like Cyprus, Switzerland etc. This is due to tax domicile purpose. MNCs (Multi- National Companies) in Japan, USA France and Germany face highest Effective Tax rate (ETR).

Home investors who establish firms abroad are required to pay income tax in either home country or the country of the host where the firm is established. This is as per double tax agreement between many countries of the world. Avoiding tax payment in atleast one country is punishable. Such tax avoidance is rampant. Making transactions of resources/assets in home country with foreign exchange without paying tax and similar transactions in rest of the world avoiding tax is called money laundering. It is punishable crime.

To Do Activity

Students can be asked to exchange foreign currencies in RBI/SBI to understand implications on national income and the concept can be discussed in the class later.

Students can be asked to make a list of Tax havens

Environmental Taxation

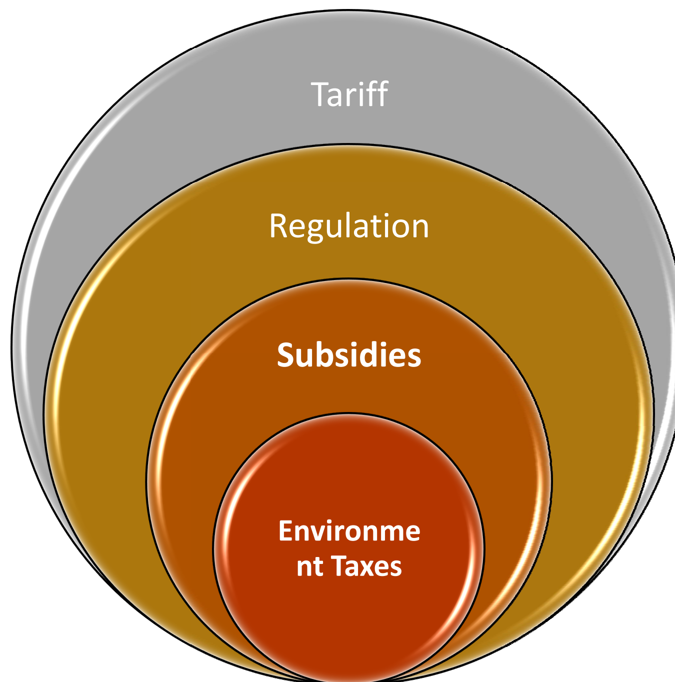

Figure 5.12 Environment Policy

Environmental taxes also called green taxes are levied on environmental pollutants or on goods on repeated use of which leads to pollution. In Economic theory positive and negative externalities are denoted. Positive externalities refer to those aspects of economic activities which increase wellbeing. Negative externalities are the aspects of economic activities which impose burden or sacrifice on the society. They are also called 'social cost. All aspects of social cost involve environment depletion. So on such negative externalities Pigouvian tax is levied. In order to wield control over social cost option is between regulatory measures along with subsidies or taxation. In environmental policy making it is a

contemporary preference to pass the burden of taking decisions about environmental norms to individual consumers and firms instead of 'command and control' way of making rules and giving subsidies. The energy and innovativeness of large number of consumers and firms will work effectively compared to dictates of the state. The convenience of automatic working of environmental policy through is preferred to legislation and implementation through imposing rules and extending subsidies. Taxes are the chosen policy through which this move is carried out. Environment Protection Agency states that well planned environmental taxes cost the firms half of that, to implement the same emission reduction through environmental regulations. It is said environmental compliance cost makes 2% of GNP in USA. This could be shifted to environmental tax system to raise 1% as revenue. Simultaneously, the same outcome is achieved at no additional burden on industry.

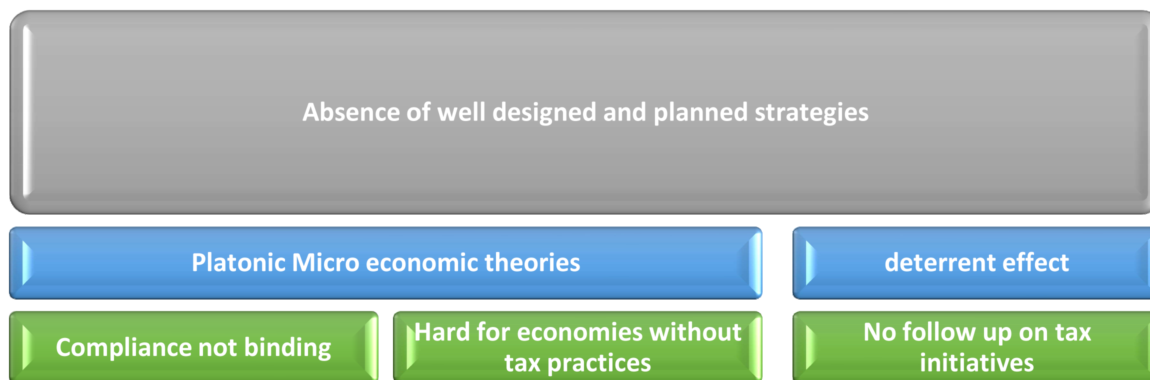

Figure 5.13 Nature of Environment Tax

Micro Economists have dominated in making a case that one of the greatest challenges of market economy is pollution. They have developed micro economic models of environmental taxes to mitigate pollution in industries. In spite of all said, there is no clear plan or process of implementing environmental taxes in most of the countries of the globe. Micro Economics gives a perspective a conceptual perspective and not that of implementation.

In many economies, the fiscal system has no income tax in order to encourage investors. It is hard to explain why environment tax should be levied and not fees. Direct subsidies could be extended in place of taxin fact cash subsidies are said to be a lavish tax credit on technological updating. But this defeats the concept of 'polluter pays' where there is burden imposed on the polluter to make him desist from polluting.

In most of the countries, the tax initiatives are not In spite of all said, there is no clear plan or process of implementing environmental taxes in most of the countries of the globe. The environmental tax initiatives do not have follow up in terms of implementation. The Government does not collect feedback about these initiatives because collecting feedback is difficult task and such feed backs tend to be biased.Theory is not averse to make pollution standards mandatory and extend subsidies as a rich credit for complying with environment standards. But this is not in line with the spirit of 'polluter pays'. Non-compliance by producers has to be deterred with environment tax on producers. It is globally agreed that polluters should pay.

In case of income tax horizontal and vertical equity is considered. But in case of environmental tax there is total bias against those who default. So efficacy is the main objective. The tax has the focus on changing the environmental behavior of the people. Producers tend to reduce production of goods on which environmental tax is levied. Excess production is remedied. Thus it also tries to cure market failure. It will change consumer behavior even though it may not eliminate market failure.

Environmental taxes are still evolving.Only recently environmental concerns have become a part of fiscal space. This is a new field requiring development. With climate change environmental considerations are considered as urgently needing policy attention. But new practicable designs are yet to emerge. At present 'carrot and stick' approach is seen in fiscal policy related to environmental taxes. That is to say those who can be made to comply with incentives (carrots) are extended.Those who donot have compliance attitude, penalty or punishment (stick) is announced.

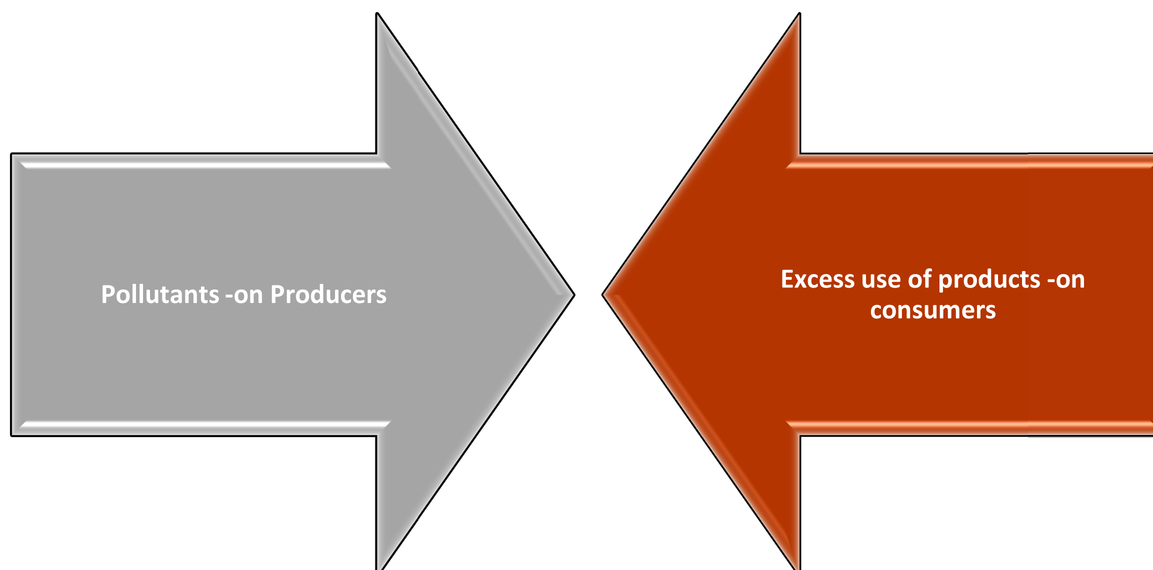

Figure 5.14 Environment Tax Burden

There are two types of environmental taxes namely producer centric emission control taxes and consumer centric taxes. In international trade it is often advocated that export taxes be replaced with emission based taxes. However, there is dearth of well -planned and well contrived environmental taxes in all economies of the globe. In developed economies there is more compliance of environmental taxes. Some examples of taxes could be given as follows:

Carbon Tax, State option to direct taxes, excise taxes to support wild life, super fund taxes, user fees, tax subsidies, reduction in sales tax for preferred items, reduction in real estate taxes for preferred items, recycling credits, accelerated depreciation for pollution control equipment, incentives to grow timber, tax credits to encourage alternative technologies or energy conservation etc.

To Do Activity

Students can be taken to interact with Pollution Control Board

Students can discuss how depletion of environment affects well being

From world development report, students can be asked to compare India's status in pollution with other countries.

India isthe 4th lowest economy which mobilizes lowest green taxes. In 2014 revenue from environment related taxes were 0.95% of GDP as compared to 2% as an average among a sample of 34 OECD economies. Energy based taxes made up for 50% of the total of environment taxes while on an average of 70% among the sample 34 OECD economies.India has the third largest emissions in the world. India was the maiden country in Asia that has been introduced nation wise carbon tax of Rs.50 per ton of coal. In 2015-2016 it was increased to Rs.200. In 2019 the present Government increased carbon tax to Rs.400/ton of coal. It is levied on production and import of coal. This is in order to stabilize and control greenhouse gas emissions. India is hereby taking into consideration growing population and high supply of coal and bio mass in the country compared to other fuels.

Green Tax on electric vehicles is relatively new in India. But RFID tags are being issued and CCTV cameras are deployed at border entry points of Delhi .Commercial vehicles entering the city are monitored of emissions ECC (Environmental Compensation Charge) is imposed on pollutants based on size of the vehicle. Original fines range between Rs700- Rs.1300 for two axle trucks and three axel trucks respectively. Now they are doubled with light vehicles and two axle trucks pay 1400 and three and four axle trucks pay2600 each time they pass the city. Government of Maharashtra imposes a green tax on private vehicles older than 15 years.Commercial vehicles used over years also will be levied with a charge. The tax has to be paid every five years. In October 205, green tax or environmental compensation charge was initiated. There is a ban on registration of diesel vehicles that come with an engine capacity of more than 2000cc.Government of Delhi has extended section 194 of motor vehicles act that denies permission to commercial vehicles to Delhi during particular times. A fine of Rs.2000 is imposed on breaking this rule.

An exclusive fiscal provision was introduced in Budget 2019 to protect environment. It announced a deduction in income tax on purchase of electric vehicles with effect from April 2020.The provision will allow deduction of interest on loans by an individual tax payer on purchase of electric vehicle (sanctioned between 2019 and 2023).The amount of deduction is capped at Rs.1,50,000. This is a fiscal measure to encourage energy efficient transport.

Chapter Summary

The Chapter explores into the stake holders in National income generation such as professions and business, international trade and environment and how taxes are applied to them. First of all the largest churners of national income, professionals and Businesses are defined. Professionals are those who provide expert services to businesses. They are levied with income tax. The term business refers to firms and households or Companies which are levied with income tax, cess and surcharge called Corporate taxes. They are largest revenue generators to the Government next only to personal income tax. They are given deductions from tax for various aspects for promoting business. How they claim Deductionsand exemptions from income tax. Here the aspects which are given corporate tax deductions are called allowables and those which aspects of expenditure which have to be accounted without tax deductions are called disallowables. Indian corporate income tax is has risen and remained constant

around 35% .Present government has decreased it by 10% and removed Dividend tax as an anti-recession measure to encourage corporate investment and allow shareholders to spend as their dividend is not taxed. The other participant in national income generation is international trade. Export and import are at optimum price (price=cost) in a market economy. But national barriers have given rise to two types of barriers namely tariff barriers. Fiscal barriers are in the form of customs duties or tax on on exports and imports. Change creating effects of tariff are consumption effect, revenue effect, redistribution effect, employment effect and BOP effect. Therefore low tariffs are preferred to encourage international trade. Exports and imports involve exchange of currencies between home country and the trading country. Exchange rate changes affect national income of countries worldwide. High exchange rate triggers imports and exports get to be costly so the demand for home exports declines. This leads to adverse balance of payments, if the demand is price elastic. Imports lead to growth of home industries. There is employment generation and national income increase. If exchange rate is low, exports increase due to increase in international demand, resulting in favourable balance of payments. Deliberate changes in exchange rate called devaluation is therefore often resorted to, by economies to increase exports and promote favourable balance of payments. National income changes also affects changes in exchange rate. A portion of rise in national income is ploughed into exports and exchange rate increases. Low national income is often followed by low exports and low exchange rate. Countries resort to tax avoidance, money laundering and tax havens due exchange rate complexities. MNCs usually have their subsidiaries in low tax economies. If MNCs are in high tax economies, their product price is high and they resort to state support (subsidies) for keeping prices low.

The most recent entrant into the world of taxation is environmental taxes. They are imposed to deter pollution. Negative externalities in the form of burden on the well -being of the people is tried to be controlled or reduced through environmental taxes. They are preferred to Environmental regulations and subsidies or subsidies because of convenience and low administrative expenditure to the Government. These taxes are yet to evolve as well designed and well panned taxes in most of the countries of the world. Most popular among them are tax on fuel and carbon tax. They are also found as tax credit for compliance. They are levied under the legal and political structure of economies. But they are imposed in two forms. Either as Pollutant based taxes on producers or on the consumers as an element of price of the product. India is among the economies collecting lowest environmental taxes. It is a tax of recent origin. The tax still has to be levied in innovative forms and more strategically.

Model Questions

1. Define Professionals and Businesses
2. Give and 5 examples of allowables
3. Cite any 5 disallowables.
4. What are the differences between allowables and disallowables.
5. Mention and any two Acts applicable to Corporate Tax and give their statements.

6. What are barriers to trade? What are the two types of barriers to trade
7. Explain with a diagram effects of tariff on the economy
8. Explain the reciprocal relationship between national income and exchange rate
9. Define Exchange rate.
10. Define devaluation
11. Write a note on Customs Duty in India.
12. What is an environment tax?
13. What are the categorical differences between other taxes and environmental taxes
14. Write a note on Indian environmental taxes.
15. Write a note on the difficulties in the evolution of environmental taxes.

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Editors' Profile

Dr W G Prasanna Kumar

Dr. W G Prasanna Kumar, Chairman, Mahatma Gandhi National Council of Rural Education (MGNCRE) prides in calling himself a *Public Servant* working for Climate Change. His expertise in Disaster Management has him in the advisory panels of several state and national level departments. He is also an expert advisor for the government of Telangana in its Disaster Response Force endeavour. A master trainer for Civil Services candidates, he conducts intensive training programs periodically at the behest of nationally recognized training institutes. He is currently actively involved in promoting higher education curriculum addressing rural concerns in India. **"Villagers to be producers not just consumers"** is his conviction that drives him to work for rural challenges. He aspires for an adaptive disaster risk resilient and eco-responsible India. The Curriculum on MBA in Waste Management and Social Entrepreneurship, and BBA and MBA in Rural Management are his major academic achievements dedicated to India's rural concerns. This has culminated in several collaboration MOUs for introduction of MBA/BBA Rural Management in Higher Education Institutions across India.

Dr. Prasanna Kumar excels in taking a vision and making it a reality and a plan into action, driven by a strong motive to achieve. He has translated positive intentions into tangible results. Being clear on the vision, defining a pathway, setting of the track with a clear destination point and quickly taking corrective actions as and when needed – are his prime qualities that make him an Achiever.

Under Dr. W G Prasanna Kumar's leadership MGNCRE has done nationally recognized instrumental work in building rural resilience including rural community engagement and Nai Talim - Experiential Learning. He has guided and helped MGNCRE in making key decisions and implementing agenda in several areas including Nai Talim (Experiential Learning), Community Engagement, Rural Immersion Programmes, Swachhta Action Plan activities, Industry-Academia Meets and Exhibitions on Waste Management, Comprehensive Sanitation Management in villages by working with Higher Educational Institutions, making curricular interventions in Waste Management and Rural Management, compiling Text Books on Waste Management and Rural Management, UNICEF (WASH) activities and several other related impactful activities. MGNCRE has become an interface for Government of India for promoting academic activity focusing on the rural concerns, being an advisor and a curriculum development agency for the Government of India. The Council is also now an RCI for Unnat Bharat Abhiyan.

Another pathbreaking achievement has been the formation of **Cells** through online workshops for institutionalising the efforts of MGNCRE. Vocational Education-Nai Talim-Experiential Learning (VENTEL) discuss MGNCRE's interventions in HEIs and making Vocational Education as a Teaching Methodology; Workshops on Social Entrepreneurship, Swachhta and Rural Engagement related activities in Higher Education Institutions has paid dividends and the key roles of the HEIs is highly appreciated by the Ministry. Building continuity and sustainability is being done through Social Entrepreneurship, Swachhta & Rural Engagement Cells (SES REC). Institutional level Rural Entrepreneurship Development Cells (REDC) Workshops/ FPO/FPC-Business Schools Connect Cells (FBSC) are organized with the objectives of

Functionality of RED Cell; Preparation and Implementation of Business Plan and grooming students to be Rural Entrepreneurs.

A man with many firsts to his credit, and an incredible record of accomplishments, Dr. W G Prasanna Kumar is currently guiding MGNCRE in building a resilient rural India.

Dr K N Rekha

Dr K N Rekha, is a PhD Graduate from IIT Madras. She has 14 years of experience in training and education Industry. She works at Mahatma Gandhi National Council of Rural Education (MGNCRE), Hyderabad as Senior Faculty. She is involved in curriculum development on Rural Management and Waste Management. Prior to this, she worked as a researcher at Indian School of Business, Hyderabad, a short stint at Centre for Organisation Development (COD), Hyderabad. She has co-authored a book on "Introduction to Mentoring", written book chapters, peer reviewed research papers, book reviews, Case studies, and caselets in the area of HR/OB. She also presented papers in various national and international conferences. Her research areas include Mentoring, Leadership, Change Management, and Coaching. She was also invited as a guest speaker at prominent institutions like IIT Hyderabad.

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