

SOME PROBLEMS OF FISCAL POLICY IN UNDERDEVELOPED COUNTRIES
WITH SPECIAL REFERENCE TO INDIA

by

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FOREWORD

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I. INTRODUCTION

This thesis attempts to fulfill three main tasks: (a) analysis of the fundamental problems of fiscal policy in underdeveloped countries; (b) delineation of the basic structure of public finance (with emphasis on tax structure) which is most appropriate for a country like India; and (c) evaluation of the basic features of the Indian tax system and fiscal policies, against the background of planned economic development.

The thesis is divided into five parts. The first part introduces the subject and discusses in broad outline some of the basic problems of economic development in a country like India, with special emphasis on capital formation. This latter problem is isolated and treated as the main key to economic development. The second part discusses the proper role of fiscal policy in an underdeveloped but developing economy. The third part contains a discussion of the most appropriate structure of public finance for such an economy. In the fourth part a critical evaluation of the Indian fiscal system is attempted. Only the basic features of the system and certain current fiscal policies are selected for treatment. The final part gives a summary of conclusions and some specific recommendations.

The greater part of the discussion is carried on with special reference to India; much of it, however, will apply with greater or less force to most other countries of Southern Asia. It is evidently not possible, within the

limits of a thesis, to deal with all the problems of fiscal policy in underdeveloped economies. As indicated in the title, some of the problems that are particularly important, especially those connected with taxation, are selected for intensive treatment.

The fiscal policy appropriate for a country will depend, apart from many other factors, on the stage of its development and on the social goals currently accepted. Therefore, the policies outlined in this thesis are those that are called for in the light of the current situation in countries that are now making desperate attempts at development. Conceivably, the presently underdeveloped countries will, sooner or later, reach a higher stage in their economic evolution. It may then be no longer considered vitally important to accelerate the rate of economic growth. In such an altered situation, all economic policies, including fiscal policy, will need to be re-oriented. The phase of development taken as background for policy, for purposes of this thesis, is the period of transition from the current state of underdevelopment to the state of self-sustaining economic growth.

A. Nature and Importance of the Subject

1. Evolution of Fiscal Theory and Policy

No other branch of economics perhaps has undergone such revolutionary developments in recent years as fiscal theory and policy. Here, as in most other fields, all the

recent innovations and developments have been with reference to advanced economies. No systematic and integrated theory of fiscal policy appropriate for an underdeveloped but developing economy has yet been formulated. This is not to say that the problems of fiscal policy in underdeveloped economies have not been receiving any attention. Indeed in very recent years many individuals and agencies have been studying these problems both at the theoretical and at the administrative levels. In particular, the United Nations has been very active in this field. The Fiscal Division of the Department of Economic Affairs has undertaken both country-by-country and subject matter studies. The Technical Assistance Administration and some of the specialized agencies also have conducted many technical assistance field missions dealing with public finance problems per se or as part of broader economic surveys. In addition, some studies have been conducted under bilateral auspices. Thus the United States has sent fiscal missions to a number of countries.¹ As a result of all this work, knowledge and understanding of the fiscal practices and problems of underdeveloped countries have significantly increased since the end of World War II.

¹For a list of reports of technical assistance missions to underdeveloped countries in the field of public finance see United Nations, Technical Assistance Administration, Taxes and Fiscal Policy in Under-Developed Countries, New York, 1954, pp. 111-118.

Nevertheless, it cannot be said that much advance has been made at the theoretical level. In the absence of an integrated theory of public finance suited to underdeveloped countries, it becomes very difficult to evaluate existing tax systems or to suggest modifications thereof. It seems opportune to bring together some important thinking done on the subject and make an attempt to evolve a theory of fiscal policy appropriate for underdeveloped economies.

Of course, even in advanced economies the concept of fiscal policy and the theory of the relation of fiscal policy to the working of the national economy are of fairly recent origin. Only thirty years ago, fiscal policy--"a policy under which the government uses its expenditure and revenue programs to produce desirable effects and avoid undesirable effects on the national income, production, and employment"¹--was practically unknown. Under the impact of depression and war, however, the theory of fiscal policy has made great strides in the last three decades. In this development Keynes's The General Theory of Employment Interest and Money has played an important part. The older objectives of minimum interference and avoidance of deficits have given place to the objective of promoting stability. In the immediate post-Keynesian period the emphasis was on short-run stability. More recently, however, there seems to have taken place a shift in favor of long-run stability. This shift is in accord with recent theoretical developments initiated by Harrod and

¹Arthur Smithies, "Federal Budgeting and Fiscal Policy," in A Survey of Contemporary Economics, The Blakiston Co., Philadelphia, 1949, p. 174.

Domar.¹ Broadly speaking, it can be said that today the primary objective of fiscal policy in advanced economies is conceived to be one of promoting conditions of stable growth.

In the Asian colonies of European powers, public finances originally were conducted on more or less the same basis as in the "metropolitan" areas. At any rate this was true of India. Apart from the use of the tariff from 1924 onwards to give protection to certain manufactures, there was no conscious attempt to influence the economy through fiscal action. (In India, until recently, fiscal policy meant tariff policy. This explains why Mr. B. P. Adarkar, a noted Indian economist, gave the title Indian Fiscal Policy to his book dealing solely with Indian tariff policy. The efforts of the Nationalists were directed mainly towards winning protection for domestic manufactures against British imports. It must be pointed out, however, that from the early years of the twentieth century a considerable volume of public expenditure was undertaken for purposes of investment. Nationalist financiers like Gokhale encouraged and demanded many desirable forms of public expenditure. India thus has a tradition of public investment in such economic overheads as highways and railroads.

When the whole basis of public finance was revolutionized in western countries, some economists in underdeveloped countries, including India, began to recommend the

¹See below, Part II, Section C, p. 65.

application of Keynesian techniques and prescriptions to their own countries. That such recommendations are unrealistic, and are even fraught with danger, is now clearly realized by most writers in the field. The policies recommended by Keynes are based on the application of his "general" theory to a particular set of conditions. The conditions in most of the underdeveloped countries differ vastly from those postulated by Keynes. A realistic and sound fiscal policy can be laid down only in relation to the economic conditions that exist in a country and the objectives that are to be achieved. Its formulation for the country concerned must take into account the stage of economic development of the country, the degree of elasticity of response of the system to economic stimuli, and the state of the economy at any given time.

It could be argued that, in a sense, the objectives of fiscal policy are more or less the same in developed and underdeveloped countries. One writer,¹ for instance, has expressed the opinion that the economic objectives of tax and budgetary policy in underdeveloped countries are to promote investment, to maintain stability, and to reduce extreme inequalities in wealth and income. These objectives, according to him, "are not basically different from the economic goals of allocative efficiency, economic growth, stability, and optimum income distribution which guide fiscal policy in

¹Walter Heller, "Fiscal Policies for Under-Developed Economies," in Taxes and Fiscal Policy in Under-Developed Countries, p. 1.

advanced countries on a free enterprise basis."¹ Such statements are quite misleading and serve no useful purpose since the tasks to be performed in developed and underdeveloped countries are essentially different. As Mr. Heller himself points out,² the apparent similarity in goals should not lead us to overlook the vast differences in economic conditions, in the legal and political environment within which fiscal policy has to be formulated, and in administrative capabilities. Such differences may require, first, that different policies be pursued even if the ultimate objectives are the same. Second, the ordering of priorities among the objectives may have to be significantly different. Broadly speaking, it may be said that whereas the maintenance of stability will be assigned first priority in an advanced economy like the United States, capital accumulation would have to be assigned first priority in an underdeveloped economy like India. This statement has to be amplified and qualified to some extent, and this is done in later sections. Meanwhile, we proceed under the assumption that fiscal policy has a vital role to play in underdeveloped countries but that the role is very different from the role envisaged for developed countries.

2. The Importance of Public Finance in Underdeveloped Countries

The great importance of fiscal policy in underdeveloped countries arises from the fact that there the state, under democratic auspices, is called upon to play an active and important role in promoting economic development. For various

¹Ibid.
²Ibid.

reasons, especially the low ratio of savings to national income, the governments of all underdeveloped countries virtually have been forced to play this role. In order to do this effectively they have to interfere in the economic life of the country, control and regulate economic activities, and compel or induce people to behave in different ways. Now the more democratic a society is the greater is the dislike for direct (physical) control and regulation by the state. For example, taxation of liquor is preferred to import quotas and tax concessions to induce entrepreneurs to expand production are preferred to direct orders to produce more. A democratic state like India, therefore, has to rely on indirect methods of regulation and over-all controls like fiscal and monetary policies. It is indeed desirable that this should be so, for increasing direct controls have proved to be extremely inefficient and may gradually pave the way to authoritarianism. "A democratic system of planning eschews direct commandeering of resources and it operates mainly through the price system."¹ Further, apart from the undesirability of direct physical controls by the state, it must be noted that as long as the government is working under the existing constitution, there are very definite limitations to what it can do by way of direct controls. It cannot commandeer resources; it cannot force people to work. Presumably, in the more authoritarian countries, such as China, the government can do this and more. However, even in Communist countries

¹Government of India, Planning Commission, Second Five Year Plan, New Delhi, 1956, p. 38.

taxation has been used in a big way to "regulate" consumption. It thus will be seen that in a democratic country fiscal policy is the most powerful and the least undesirable weapon of control which the state can employ to promote economic development.

There is another reason why public finance assumes importance in underdeveloped countries. As stated above, capital accumulation is the key problem which these countries are called upon to tackle. They have to achieve a higher ratio of savings to national income than exists at present. Early capitalism and modern communism were able to achieve this high ratio by keeping down the level of living of the people--in the one case by low wages and great inequality of incomes, and in the other case by a dictatorial restriction of resources allocated for the production of consumer goods. Neither of these methods is open to the underdeveloped countries which have chosen the democratic way. The temper of the times simply will not tolerate very great inequality of incomes and of wealth which may be considered necessary if we are to rely on private investment alone. There is a clamor especially for higher and higher wages. It is difficult to resist this clamor so long as the rich are allowed to indulge in conspicuous consumption. The only way out of the dilemma seems to be to have recourse to public investment to a significant extent, side by side with private investment. Taxation could be used to insure collective savings and at the same time promote private investment. By this means the sacrifices involved in capital formation can be distributed

more equitably and the poorer sections may be assured that all classes are making sacrifices in potential consumption. Taxation, if well-conceived, also is the best means of raising the incremental saving ratio, which is one of the crucial determinants of growth. It is probably on these grounds that Professor Ragnar Nurkse says: "I believe that public finance assumes a new significance in the face of the problem of capital formation in underdeveloped countries."¹ Indeed, in many countries autonomous savings are so low that whether or not rapid development can take place will depend on whether the state is willing and able to promote private savings and/or insure collective savings through taxation.

In a country like India with a quasi-planned economy, there is yet another factor which makes fiscal policy important. India is now in the third year of her Second Five-Year Plan, 1956-1961. The first plan was scarcely more than a program of governmental expenditure and a summary of the country's needs and resources. By contrast, the second plan is more of a "plan" and an attempt was made to formulate it in real terms, at least as far as the broad economic magnitudes and the strategic factors in the economy were concerned. Such a physical plan must be matched by a financial plan. As the Planning Commission of India puts it:

There has to be, in other words, certain balances in the plan in terms of real resources. A plan unfolds itself in first upsetting an existing balance and then establishing a new one at a

¹Ragnar Nurkse, Problems of Capital Formation in Underdeveloped Countries, Oxford University Press, New York, 1953, p. 143.

higher level. ...It must be emphasized that the balance to be achieved in the plan has to be both in real and financial terms. Money incomes are generated in the process of production, and supplies are utilised in response to money demands. It is important, therefore, to operate upon and modify money income flows so as to maintain a balance between the supply of consumer goods and the purchasing power available for being spent on them, between savings and investment and between receipts and payments abroad.¹

The implementation of the financial plan and the achievement of balances in money terms obviously will have to rely largely on fiscal and monetary measures. Indeed if certain fiscal measures required by a physical plan are politically impossible or economically unattainable, then the physical plan itself will have to be modified. Thus, as an adjunct to a physical plan and as a substitute for it in spheres where no such planning is adopted, fiscal policy has an important role to play in the developmental programs of underdeveloped countries.

B. The Characteristics of Underdevelopment

1. Some Salient Characteristics of an Underdeveloped Economy

It may seem somewhat arbitrary to classify national economies into "developed" and "underdeveloped" and treat them as two more or less homogeneous groups because individual countries in each group have their own peculiar characteristics. Nevertheless, the so-called underdeveloped countries differ in some significant respects from the economically advanced countries and these differences are of importance

¹Second Five Year Plan, pp. 15 and 16.

for policy formulations. We may therefore describe briefly some of the salient characteristics of underdeveloped economies and contrast them with the distinguishing characteristics of developed economies.

a. Definition of an Underdeveloped Economy. It is difficult to define an underdeveloped economy. In current discussions, all poor countries are classified as underdeveloped. An underdeveloped economy has been defined by some United Nations experts as one in which "on the whole, production is carried on with a relatively small amount of real capital per head and with relatively backward techniques in the broadest sense of the word."¹ A somewhat more satisfactory definition for our purposes would be the one given by E. M. Bernstein:

The best test of an underdeveloped country is its level of real income and the rate at which per capita real income is increasing. In short, an underdeveloped country is one in which output per capita is relatively low and in which productive efficiency is increasing very slowly, if at all.²

Thus an underdeveloped economy is poor and it finds it very difficult to get rid of its poverty. Behind the use of the term "underdeveloped" is also the implication that the country concerned has certain potentialities for development.

¹United Nations, Methods of Financing Development in Underdeveloped Countries, New York, 1949, p. 90.

²E. M. Bernstein, "Financing Economic Growth in Underdeveloped Economies," in Savings in the Modern Economy, ed., Walter W. Heller, the University of Minnesota Press, Minneapolis, 1953, p. 267.

As pointed out earlier, there are great differences among the underdeveloped countries themselves. Some are richly endowed with natural resources, others are deficient in many respects; some are almost wholly agricultural, others have an industrial structure of some sort; some possess very advanced civilizations, others are still in the tribal state; and so on. From the economic point of view, however, underdeveloped countries can be divided broadly into two groups. To the first category belong those countries which are overpopulated and consequently have a considerable amount of surplus labor subsisting on land; to the second belong those which are not over-populated and therefore do not experience an acute pressure of population on land. The problems of the two groups of countries are, in some respects, different. In this thesis we are concerned mainly with the first category of countries, to which India herself belongs.

b. Income and Investment Levels. As is well known, most of the underdeveloped countries have deplorably low incomes. A United Nations study of national income per capita in United States dollars for seventy countries, for 1949, clearly brings this out.¹ It is seen that 25 countries, together accounting for half of the population of the 70 countries covered by the survey, had per capita annual incomes of less than \$100 in 1949. A comparable set of estimates for 1953 has been prepared by the Center of International Studies

¹United Nations, National and Per Capita Incomes of Seventy Countries, 1949, New York, 1950, p. 13.

of the Massachusetts Institute of Technology.¹ These estimates give slightly higher figures, partly because of rise in prices and partly because of growth in output. But the general picture remains more or less the same. It has been pointed out that the United Nations figures represent grave underestimations of the actual per capita income figures of the underdeveloped countries. They contain many statistical errors because of the crudity of the initial income estimates. The original figures in local currencies themselves are underestimates because, for lack of data, part of the output, especially non-monetary output, gets excluded. The conversions into dollars inevitably introduces a further downward bias because the internal value of the local currencies is higher than is indicated by their dollar values. Nonetheless, the general impression afforded by the figures is substantially correct. Even if we make allowances for systematic bias in estimation, the differences between the per capita incomes of developed and underdeveloped countries are truly staggering. For instance, Mr. M. F. Milikan has offered an estimate that the real income of Asian countries (excluding the Middle East) was probably around \$195 in 1950 when allowance is made for all biases.² This figure is to be compared with the per capita income of over \$1800 for the United States.

¹Reproduced in Charles P. Kindleberger, Economic Development, The McGraw-Hill Book Company, Inc., New York, 1958, p. 13.

²Quoted in Charles P. Kindleberger, op. cit., p. 2.

One consequence of the low level of incomes is the low rate of savings and investment. Typically, underdeveloped countries channel less than 10 per cent of their low incomes into net investment every year. Six or seven per cent seems to be the average figure for the underdeveloped countries of Asia. In the ECAFE¹ region, only Japan with a net capital formation of 20 to 26 per cent of national income and Burma, to a lesser extent, have a rate of capital formation sufficient for improving the level of living of the population.² A small ratio of investment to national income permits of only a small annual rise in national income. This rise in income is counterbalanced by the annual increases in population. If we assume a marginal capital/output ratio of 4 : 1,³ annual net investment equal to 5 per cent of the national income will lead to an increase of 1.25 per cent in income per year. With population increasing at the current Indian rate of roughly 1.25 per cent per year, therefore, a rate of investment of 5 per cent of national income would be just about sufficient to maintain per capita income at the present level. If the population should increase at the rate of 2 per cent per year, net savings would have to be 8 per cent

¹Economic Commission for Asia and Far East.

²Economic Bulletin for Asia and Far East, Vol. V, No. 3, November 1954, p. 1.

³It is, of course, almost impossible to calculate exactly the over-all marginal capital coefficient for underdeveloped countries. The Economic Commission for Asia and Far East inferred a coefficient of 5 to 3 from the calculations of many statisticians (Economic Bulletin, ECAFE, Vol. III, No. 2, November 1952, p. 1). The first Indian Five-Year Plan assumed a ratio of 3 : 1, but is said to have realized 1.8 in practice.

to maintain per capita income; and 12 per cent would be required to permit a rate of growth in per capita income of 1 per cent yearly. Since this higher level of savings has not been realized in underdeveloped countries, their per capita incomes have been fluctuating around a low level from year to year. In Egypt and India, for example, per capita real consumption in the post war years was estimated to have been somewhat lower than in 1938.¹ In India, since the inauguration of the First Five-Year Plan, per capita income has shown a slight but steady increase, but the improvement is scarcely perceptible and the rate of savings was only around 7 per cent in 1955-56.

Such stagnation in respect of per capita incomes should not lead one to suppose that all these countries are in a hopeless state of underdevelopment equilibrium. Considerable progress has been achieved, in some of the countries at any rate, in the matter of establishing the basic foundations for future advance. In the past 60 or 70 years, new products have been developed and considerable success has been achieved in exploiting newly-discovered natural resources. It is true that much of the advance has been concentrated in the sphere of export and extractive industries. But the progress already achieved and the modernization already effected in some sectors of the economy hold out definite hopes for the future, if only these countries can succeed in raising their level of investment.

¹E. M. Bernstein, op. cit., pp. 267-268.

c. The Vicious Circle of Poverty. It is suggested usually that underdeveloped countries suffer from the vicious circle of poverty. The vicious circle operates on both the supply and the demand sides. First low incomes lead to low levels of savings and investment. The low rate of investment in turn leads to the perpetuation of low incomes and the circle is completed. This is the vicious circle on the supply side. Second, the low rate of investment keeps productivity and incomes low. Therefore, the purchasing power of the people in real terms is low. This leads to a relatively low private marginal productivity of investment. Inducement to invest being low, low incomes are perpetuated. This is the vicious circle on the demand side. To be sure, the concept of the vicious circle of poverty only partly explains the perpetuation of low incomes. For instance, given the existing skewed distribution of income and property in underdeveloped countries, the potential rate of savings cannot be related directly to the level of per capita incomes. And there is evidence to show that a considerable part of investment, when unchecked, is directed into unproductive channels. Low incomes, therefore, are not the only cause of low rates of savings and investment. It is by tackling the other causes of low investment that we can hope to break out of the so-called vicious circle.

d. Agriculture and Disguised Unemployment. The underdeveloped countries of Asia and Africa are predominantly agricultural. The great majority of the population, some 70 to 80 per cent, are engaged in agriculture and allied

occupations. It is to be expected that in low-income countries a major part of the effort will be devoted to agriculture, since, at low income levels, the proportion of income spent on food is very high. Another, and probably more important, reason is that non-agricultural occupations have not been growing at a rate commensurate with the increases in population, for lack of sufficient investment outside of agriculture. Hence, a growing labor force has had to be absorbed in agriculture. With the accelerated growth of population in the last few decades, the pressure of population on the available land has become very great and has produced serious consequences. The labor-land ratio being high, agricultural holdings have become sub-divided into small plots which will not permit the use of modern mechanical methods of cultivation. Though land is scarce and is intensively cultivated, the yield per acre generally is low in comparison with that in the advanced countries of western Europe.¹

Another major characteristic of agriculture in the underdeveloped countries of Asia--a corollary of the pressure of population on land--is that a considerable part of the population now subsisting on land really is surplus to the needs of agriculture and can be said to be in a state of disguised unemployment. In technical terms, the marginal productivity of labor in agriculture is zero. This underemployment of labor is one clear evidence of over population

¹Harvey Leibenstein, Economic Backwardness and Economic Growth, John Wiley & Sons, Inc., New York, 1957, p. 48.

and the abundance of the labor factor in relation to the other factors of production. Needless to say, no accurate measure of surplus labor can be had. But the recent All-India Agricultural Labor Enquiry Committee estimated that there are at least 25 million man-years of surplus labor power in the rural sector in India. Only a sufficiently rapid growth of non-agricultural occupations can absorb this surplus labor which is presently running to waste. As Professor Leibenstein points out, "The persistence of a lack of adequate non-agricultural employment opportunities lies at the very root of the economic development problem. ...The lack of alternative employment opportunities outside of agriculture, the fact that the predominant portion of the labor force is engaged in agriculture, and the existence of agricultural underemployment are different aspects of the same phenomenon."¹

e. Organization of the Economy and Foreign Trade.

Traditionally, underdeveloped countries have exported raw materials and imported finished consumer goods and machinery. By and large, this is still true of the countries of Asia, though India herself is coming now more and more to export manufactured goods and to import machinery and industrial raw materials. Raw material exports, however, still form a large part of total exports. Foreign trade plays an important part in the economies of underdeveloped countries; some of the

¹Ibid., p. 51

countries like Burma and Thailand can be called export economies in so far as a significant part of the national output of these countries is exported. In all the countries that part of the economy which is engaged in export and import activities is the most organized sector of the economy, along with certain factory enterprises varying in scope and size from country to country. There is a curious mixture of the modern and the primitive in the economy of India. A part of the economy (mentioned above) is organized and modern while the rest is unorganized and primitive. To the latter belong the handicrafts and all of agriculture except the plantations. The organized sector is very similar in many respects to an advanced economy. It is responsive to economic stimuli. By contrast, the unorganized sector is tradition-bound and backward, and a considerable part of it is outside the monetary system. It must be remembered that subsistence agriculture and self-consumption still are very much the rule in the rural sector.

2. ✓ The Characteristics of a Developed Economy--a Contrast

We may contrast the above-mentioned characteristics of underdeveloped economies with those of advanced economies. The latter have a high level of per capita incomes and a relatively high ratio of savings to national income. In most of the advanced economies the rate of net investment ranges from 12 to 15 per cent of the national income. If population increases by about 1.5 per cent, annual net investment of about 15 per cent would permit an increase in per

capita income of about $1\frac{1}{2}$ to 2 per cent per annum,¹ which is roughly the observed average rate of growth in the advanced economies. Thus in the advanced economies the increase in per capita incomes is fairly rapid and almost automatic, unless the economy moves off the equilibrium path and the forces of depression bring about a temporary setback. The problem then is not to find the necessary savings, but rather to regulate the rate of investment to insure conditions of stable growth.

An advanced economy is highly organized and integrated. It is, in a true sense, a monetary economy and is highly responsive to economic stimuli. It is, therefore, susceptible of being regulated and controlled by monetary and fiscal devices. As the economy is highly integrated, it has been possible to formulate certain models concerning relationships among the strategic variables that govern the behavior of the economy. By manipulating these variables, it is hoped to influence and regulate the economy.

It is sometimes feared that with a high ratio of savings to national income and with continuous additions to productive capacity, an advanced economy, left to itself, may tend towards an underemployment equilibrium. The mature economy thesis is based on this fear. The underdeveloped countries, on the other hand, tend to stagnate at low levels of income, in the absence of positive measures by the government.

¹Assuming the same marginal capital/output ratio as before.

Most of the advanced economies are industrial economies. The secondary and tertiary sectors clearly outweigh the primary sector in importance in terms of contribution to national output and to employment. Only a small proportion of the total labor force is engaged in agriculture. Generally speaking, in both industry and agriculture, capital-intensive methods of production are employed. This is because of a relative abundance of capital and a relative scarcity of labor.

In an advanced economy, though there may exist at any given time a certain volume of underemployment, in the sense of labor being engaged in relatively unproductive occupations, the most significant type of unemployment takes the form of "visible," involuntary unemployment as distinguished from the disguised unemployment encountered in underdeveloped countries. The latter is due to a lack of complementary factors of production, whereas the former arises owing to fluctuations in effective monetary demand.

3. A Brief Description of the Indian Economy

a. Physical Features. The Republic of India covers an area of 1,269,640 square miles, including Jammu and Kashmir. It has a land frontier of 8200 miles and a coast line of 3500 miles. It is roughly two-thirds the size of Europe excluding Russia, and is the seventh largest country in the world. It is bounded on three sides by sea. Its land frontier extends from the northwest to the northeast; it is bounded by West Pakistan in the northwest, by the Himalayas in the north, and by East Pakistan and Burma in the northeast. On the other

side of the Himalayas lie the boundaries of the Soviet Union, Tibet, and China. India thus occupies a strategic position in South Asia.

Physically, India can be divided into three main regions. The first is the ~~Himalayan~~ region, which stretches from Kashmir in the west to Burma in the east, with a length of 1700 miles and an average width of 200 miles. This region acts as a natural protective wall and also provides rain water for the plains below by arresting the moisture-bearing clouds of the Southwest Monsoon. It is a region of great scenic beauty and contains rich animal and forest resources. The second region is the Indo-Gangetic Plain which lies between the Peninsula and the Himalayan region, extending east-west for about 1500 miles. As the name indicates, the plain is watered by two great river systems, the Indus and the Ganges with their many tributaries. A third great river, the Brahmaputra, cuts through the Himalayas in the west and joins the Ganges to form a great delta. The Indo-Gangetic plain covers an area of 300,000 square miles and is the most fertile and developed region. The third region is the Deccan. It is a great plateau which rises from the river plains of the north and the coastal plains in the east and west of peninsular India. It is a table-land raised above sea level from 1500 to 4000 feet and is broken up into many river valleys. It is traversed by some important rivers like the Nerbada, the Godavari, the Krishna, and the Cauvery.

b. Natural Resources. The total geographical area of India is 810.26 million acres. Leaving aside 196 million

acres, for which no statistics are available, the remaining 615 million acres are distributed as shown in Table I.

Table I

LAND AREA OF INDIA AND ITS CLASSIFICATION

	<u>Million Acres</u>	<u>Percentage of Total</u>
1. Forests	93	15
2. Net area sown	266	43
3. Current Fallows	58	9
4. Cultivable waste	98	16
5. Not available for cultivation	96	16
Total ¹	615	100

Source: First Five Year Plan, p. 77.

The cultivated area comes to 324 million acres. The gross cropped area is about 317 million acres, of which food grains occupy about 78 per cent. Little new area came under cultivation during the 40 years prior to the First Plan. In the 30 year period since 1921, the area cultivated per capita dropped steadily; from 1.11 acres in 1921 it came down to .84 acre in 1951. To some extent this was counterbalanced by the extension of double cropping. It is clear that there has been a mounting pressure of population on land, especially since 1921.

¹Includes about 4 million acres of unclassified areas. Hence the 5 categories given in the table do not add up to 100 per cent.

The mineral resources of India, as known at present, contain an adequate range of useful products that are necessary for the industrial development of the country. In respect of coal and iron, the resources are ample; indeed India's deposits of high-grade iron ore are among the richest in the world. The reserves of workable coal were estimated originally at 20 billion tons.¹ The reserves of coking coal were placed at 2 billion tons only. Though the coal reserves may be considered fairly adequate for the plans of industrialization, the position in regard to coking and semi-coking coal is not altogether satisfactory. Recent resurveys of some of the coal fields, however, have indicated substantially larger reserves of coal and the possibility of finding more coking coal.² In the matter of iron ore India is much better placed. The reserves of good quality iron ore are estimated to be over 10 billion tons. In most cases the ores have a high percentage of metallic iron and are relatively free of phosphorous and sulphur.

Of the other minerals that India possesses, manganese is the most important. Large deposits of this mineral occur in India and they are of special importance because they are needed in the iron and steel industry. The other minerals of which India has large reserves are titanium, thorium, mica, bauxite, ilmenite, monazite, and lignite; supplies of

¹These estimates of mineral resources in India are taken from First Five Year Plan, People's Edition, Government of India, New Delhi, 1953, pp. 164-73.

²Second Five Year Plan, p. 373.

refractories, abrasives, and limestone are said to be fairly adequate. It must be pointed out, however, that the country is deficient in some important minerals like copper, tin, lead, sulphur, and above all, in reserves of petroleum. Further exploration and survey have yet to be carried out and these may disclose deposits of some of these minerals.

c. Demographic Characteristics. According to the 1951 census, the total population of India in 1951 was around 360 million.¹ The birth and death rates are, respectively, 40 and 27 per thousand per year, thus resulting in an incremental rate of 1.3 per cent per year. This is the observed annual rate of growth during the decade 1941-50. As the death rate has been falling since the turn of the century, without a corresponding fall in the birth rate, the population of the country has been increasing at an increasing rate during the last 3 or 4 decades. Thus the average annual rate of growth was 1.04 per cent in 1921-30, 1.27 per cent in 1931-40, and 1.32 per cent in 1941-50. At the current rate the annual increase in population in absolute numbers is 4.5 to 5 million. This number naturally would rise in the coming years. Thus the task of economic development is rendered as difficult as it is urgent.

The occupational distribution of the working population is quite revealing and indicates the agrarian and the relatively undeveloped nature of the economy. Of the total

¹The figures relating to population are taken from The Report of the Census Commissioner, Census of India--1951.

population of 360 million in 1951, 143.2 million made up the working force. Of this 72.4 per cent was engaged in agriculture including animal husbandry, forestry, and fishing; 10.6 per cent in mining, manufacturing, and handicrafts; 7.7 per cent in commerce, banking, transport, and communications; 4.4 per cent in professions and liberal arts; 2.7 per cent in government services; and 2.0 per cent in domestic service.¹

d. National Income and Its Distribution. It is not possible to trace the growth of national income in India over a period of many years, since authoritative estimates are not available for years earlier than 1948-49. The first authoritative and official estimate of national income was made for 1948-49 and figures are available for subsequent years. For 1948-49, national income was estimated to be Rs 86.5 billion, with per capita income standing at Rs 246.9.¹ The growth in national and per capita incomes in subsequent years up to 1954-55 is shown in Table II on page 29. Latest estimates available are for 1955-56 (final) and 1956-57 (preliminary). According to the fifth issue of the Annual Paper on National Income, India's national income at 1948-49 prices was Rs 104.80 billion in 1955-56 and Rs 110.10 billion in 1956-57; the per capita income figures for the two years were Rs 273.6 and 284.0, respectively, at 1948-49 prices.² Thus national

¹India--1956, Government of India, New Delhi, 1956, p. 92. At the current rate of exchange, a rupee is the equivalent of \$0.21.

²Quoted in International Monetary Fund, International Financial News Survey, Vol. X, No. 42, May 2, 1958, p. 338. The estimates for 1956-57 are preliminary and are subject to revision.

income grew from Rs 86.5 billion in 1948-49 to Rs 110.10 billion in 1956-57; and per capita income from Rs 246.9 to 284.0.

The distribution of national income by origin in absolute figures and in percentages, for 1953-54, is given in Table III on page 30. It is seen that the contribution of agriculture, including forestry and fishing, came to over 50 per cent and that mining and manufacturing contributed only 16.9 per cent. Of this, the share of large-scale factory enterprises was only 6.6 per cent. The predominant share of agriculture in national income is clearly brought out. It is to be remembered that 72.4 per cent of the working population is engaged in agriculture and allied occupations. Factory enterprises employ only about 2.4 million persons.

Table II
NET NATIONAL PRODUCT OF INDIA 1948-49 TO 1954-55

	1954-55 ^a	1953-54	1952-53	1951-52	1950-51	1949-50	1948-49
Net National Product at Factor Cost in Billions of Rupees							
1. At current prices	99.1	104.9	98.2	99.7	95.3	90.1	86.5
2. At 1948-49 prices	101.7	100.4	94.6	91.0	88.5	88.2	86.5
Per Capita Net Product in Rupees							
3. At current prices	262.1	281.0	266.4	274.0	265.2	253.9	246.9
4. At 1948-49 prices	269.0	269.0	256.6	250.1	246.3	248.6	246.9
Index Number of Net National Product with 1948-49 as Base							
5. At current prices	114.6	121.3	113.5	115.3	110.2	104.2	100.0
6. At 1948-49 prices	117.6	116.1	109.4	105.2	102.3	102.0	100.0
Index Number of Per Capita Income with 1948-49 as Base							
7. At current prices	106.2	113.8	107.9	111.0	107.4	102.8	100.0
8. At 1948-49 prices	109.0	109.0	103.9	101.3	99.8	100.7	100.0

Source: Estimates of National Income 1948-49 to 1954-55, Central Statistical Organization, Government of India, 1956, p. 1. ^apreliminary.

Table III
DISTRIBUTION OF NATIONAL INCOME BY INDUSTRIAL
ORIGIN--INDIA, 1953-54

	<u>Billion Rs</u>	<u>Per Cent</u>
1. Agriculture and Allied Activities		
a) agriculture and animal husbandry	52.0	49.6
b) forestry	0.7	.6
c) fishery	<u>0.5</u>	<u>.5</u>
Total	53.2	50.7
2. Mining, Manufacturing, and Small Enterprises		
a) mining	1.0	1.0
b) factory enterprises	6.9	6.6
c) small enterprises	<u>9.8</u>	<u>9.3</u>
Total	17.7	16.9
3. Commerce, Transport, and Communication	18.0	17.2
4. Other Services (professional, government, domestic, and house property)	<u>16.0</u>	<u>15.2</u>
National Income	104.9	100.0

Source: Estimates of National Income, Central Statistical Organization, Government of India, New Delhi, 1956, pp. 2-3; adapted.

e. Foreign Trade and Organization of the Economy.

Exports play an important part in the Indian economy, although the proportion of the value of exports to national income is not as high as in many other underdeveloped economies. In 1953-56, exports of goods and services formed 6 per cent and imports 5.8 per cent of net national product, inclusive of imports.¹ This relatively small percentage notwithstanding, foreign trade exercises an important influence on the economy. That part of the economy which is engaged in foreign trade is the most organized sector of the economy and, along with the factory enterprises, assumes a leading position. The organized modern banking and monetary structure has grown up around these sectors. Fluctuations in international prices are transmitted to the economy at large through the foreign trade sector. Considering the value of this sector's contribution to total output, its influence on the economy is disproportionate. One reason is that it is highly organized, while a greater part of the rest of the economy is unorganized.

In India, as in many other underdeveloped countries, one observes the dichotomy between the organized and unorganized sectors. One part of the economy, comprising the foreign trade sector, the small sector of factory enterprises, and the modern monetary institutions, is modern and highly organized; the other part of the economy, consisting of all of agriculture except the plantations and of small-scale enterprises, is unorganized and primitive in many respects. The

¹Estimates of National Income, p. 7.

two sectors are not closely integrated. The organized money market, for instance, is almost out of touch with the rural sector. In recent years an attempt has been made to integrate the money markets in the economy through the spread of the cooperative movement and the establishment of a State bank (the State Bank of India) with a large number of branches. One of the tasks involved in promoting economic progress consists in spreading the influence of modernization within the backward sector and integrating it with the more advanced sectors of the economy.

A gradual change in the composition of India's exports and imports has been taking place since the first World War. The change has been accelerated by the second World War, Partition, and the recent efforts at speedy economic development. In the nineteenth century much of the greater part of India's exports consisted of foodstuffs like wheat, rice, and tea; raw materials such as cotton, jute, oil seeds, and hides and skins; and some minerals like manganese and mica. In exchange for these exports were obtained imports of manufactures, first from England, and later from Germany, the United States, and Japan. In the last quarter of the nineteenth century, however, an indigenous cotton textile industry began to grow up; and World War I gave a stimulus to some other Indian industries. This made possible an increase in the export of manufactures. In the inter-war period, a policy of protection led to the growth of a number of consumer goods industries whose output could replace imports in a number of directions. World War II accelerated

this development. With the growth of industries it has become necessary to import some industrial raw materials. This has been especially so since Partition, which has made India a net importer of food, raw cotton, raw jute, and hides, as some of the important areas producing these raw materials went to Pakistan.

The current position in regard to Indian foreign trade is, in summary, that India is coming to import more and more of machinery and industrial raw materials and to export processed raw materials and manufactured goods. Nevertheless, raw material exports still form a considerable proportion of total exports. Indian exports consist of the following items: tea, jute manufactures, raw cotton and cotton manufactures, vegetable oils, metallic ore and scrap iron, coal, chemicals, and some light engineering goods. Of these, as much as 56 per cent of the total value of exports is accounted for by 3 commodities, namely, jute manufactures, cotton manufactures, and tea.¹ Indian imports consist largely of the following items: machinery and vehicles, iron and steel, other metals, foodstuffs, sugar, mineral oils, raw cotton, raw jute, and many kinds of manufactured consumer goods. Machinery and vehicles constitute the largest single item. The total value of exports (of merchandise) in 1954-55 stood at Rs 5.96 billion, and of imports at Rs 6.55 billion.²

¹First Five Year Plan, People's Edition, p.200.

²Second Five Year Plan, pp. 96 and 99.

f. Indian Industries. The relative backwardness of industrial development in India may be judged by the fact that, in 1953-54, factory establishments accounted for only about 6.6 per cent of the total national income.¹ While the total Indian industrial output is considerable, the per capita output is very low compared with that of advanced countries.

Before the first World War the only major industries which had developed substantially were cotton and jute textiles. The inter-war period witnessed the growth of a number of industries like cotton textiles, iron and steel, paper, sugar, cement, matches, glass, soap, etc. The second World War and the scarcity and inflationary conditions which followed in its wake gave considerable stimulus to Indian industry. Old industries expanded and a whole range of new industries came into existence. Thus there have been established in the war and postwar years the locomotive, automobile, ship-building, bicycle, sewing-machine, diesel engine, textile-machinery, ball and roller bearing, and rayon industries--to mention only the more outstanding.

Up till now the major emphasis in industrial development in India has been on consumer goods industries, while the basic capital and producer goods industries have not been developed sufficiently. The existing capacity for the production of capital and producer goods is in most cases quite inadequate even to meet present requirements. One of

¹Supra, p. 30.

the important objectives of the Second Five-Year Plan is to make good some of the deficiencies in this sector of the economy.

II. ROLE OF FISCAL POLICY IN UNDERDEVELOPED ECONOMIES

A. Keynesian Analysis and Underdeveloped Countries

As indicated earlier, for the most part the theory of fiscal policy has been developed with reference to advanced economies. As such/^{it}is oriented primarily towards the need of maintaining full employment against cyclical recession. Indeed, it is the direct outgrowth of the Keynesian theory of employment and income, and the dynamic models built on that basis in recent years. On the basis of Keynesian analysis, deficit spending is advocated as one of the means of curing involuntary unemployment in advanced economies during a period of recession or depression.

In the early post-Keynesian period, there were some who suggested Keynesian solutions to some of the problems of underdeveloped countries, notably to the problem of unemployment. Since a considerable volume of unemployment existed in India, it seemed plausible to them, by a mere transposition of the concepts developed in England, that deficit spending could be used to raise the level of employment in India. This argument, needless to say, arose from a complete misunderstanding of the nature of unemployment in India as well as of the way in which the Indian economy functions. This will be brought out clearly if we examine the consequences of an attempt to increase investment and employment

in India by means of deficit spending.¹

Our present object is to see what happens if the government tries to reduce the volume of unemployment and under-employment that exists in India even under normal conditions, that is, even in the absence of what may be called a recession. Let us, therefore, assume that there is no slack in the economy in the form of significant excess capacity in industries. As we know, the economy is predominantly agricultural. The capital employed per head is extremely low and conditions do not exist in which capital equipment can be increased rapidly. The vast majority of earners fall under the category of self-employed persons. A significant proportion of the national output does not enter the market but is consumed by the producers themselves. Lastly, the supply of agricultural products as a whole is relatively inelastic.²

Under these circumstances, an increase in investment leads first to an increase in income and employment. The next increase should come from a secondary increase in income, output and employment in the consumption goods industries. It might be expected that since the marginal propensity to consume is high, the value of the multiplier would be high

¹The meaning of "deficit spending," in the sense in which the term is used in India, is discussed in a later section. The term is used here to mean any government spending in excess of current revenues that has the effect of increasing total outlay in the community.

²Some would hold that the supply curve of agricultural products in underdeveloped countries is likely to be backward-sloping.

and the ultimate increase in income and employment should be considerable. This is really not so because the consumption goods industries, to which the initial increase in demand is directed, cannot readily increase output and offer additional employment.

Let us first take the food industry. In India this means agriculture. Whether or not the agricultural sector can immediately increase its output is important because the expenditure on food forms no less than 63 per cent of total expenditure in India. An immediate increase in the output of food and of raw materials is very unlikely. The supply curve for agricultural products, as already pointed out, is steeply sloped, at any rate in the short period. Agriculture depends on the vagaries of nature; the lag between input and output is longer than in industry; and the small-scale agriculturists are not in a position to command the necessary capital resources to increase output. Thus, though the initial increase in income does get spent to a large extent on the output of agriculture and consequently leads to an increase in the income of agricultural producers, they do not correspondingly increase their output and add to national income. The result tends to be an increase in the price of food articles.

The tendency for prices to rise is strengthened by an additional fact. The increase in the incomes of agriculturists will increase their consumption. In so far as they increase their consumption of food, the marketable surplus of food is reduced. This tends to intensify the rise of

food prices to the non-agricultural sector.

Part of the increased income of the investment workers and the agriculturists will be directed towards non-agricultural commodities. But the possibility of increasing non-agricultural output is not much greater than in the case of agricultural products. This is so because we have assumed that there is not much excess or idle capacity in industries producing consumer goods. Thus, though the tertiary increase in money income takes place (as a result of the spending by agriculturists), there is no corresponding increase in either output or employment. From the initial spending on investment, every successive round of spending increases money income, but not real income or employment, at least not to any significant extent. As Dr. V. K. R. V. Rao puts it: "The multiplier principle, therefore, works with reference to money income but not with reference either to real income or employment."¹ In other words, deficit spending in an underdeveloped country will initiate a process of inflation, even though there is admittedly a large volume of unemployment.²

It might be argued that some excess capacity of capital equipment and even of land may normally exist in many underdeveloped countries. Even if such excess capacity exists,

¹V. K. R. V. Rao, "Investment Income and Multiplier in an Underdeveloped Economy," Indian Economic Review, Vol. I, No. 1, February 1952, p. 60. The analysis given here closely follows Dr. Rao's reasoning.

²If deficit spending occurs at a moment when real income is rising as a result of past investment, inflation may not result. The case for such deficit financing undertaken in the course of economic development stands on a different footing and will be considered later.

many of the complementary resources needed to expand output may be in short supply. It may be virtually impossible to increase their supply, or possible only with very high increases in prices. A number of such "bottlenecks" suggest themselves: electricity, fuel, imported raw material, transport, repair facilities, credit facilities, etc. Any attempt to increase output will be confronted by these bottlenecks; and they can be overcome only by considerable rise in the prices of resources concerned. If the bottlenecks are intractable and wide-spread in the economy, the rise in prices may tend to become general. It may be remembered that Keynes, in his reformulation of the quantity theory of money, pointed out that as soon as the bottlenecks were reached, there would tend to be a rise in prices of some commodities.¹ The difference between industrial countries and underdeveloped countries is that the latter cannot assume, as the former can, that unemployed resources of every type are readily available in short order as a result of small price increases. As Dr. Adler points out, under these circumstances true inflation may start long before full employment is reached.²

1. Deficit Spending and Under-Employment

The above conclusion is corroborated by the experience of many underdeveloped countries during the war and post-war years. These countries indulged in considerable amounts of

¹Keynes, General Theory, p. 300.

²John H. Adler, "Deficit Spending and Supply Elasticities," Indian Journal of Economics, Vol. XXXVII, No. 144, July, 1956, p. 29.

deficit financing, first for prosecuting the war, and later for purposes of reconstruction. This resulted in a good deal of inflation and monetary instability. It is quite clear that underdeveloped countries cannot rely upon deficit spending as a short route to full employment and higher output. The great volume of under-employment and unemployment that one finds in an overpopulated country arises from a lack of complementary factors of production that can be combined with labor, and not because of a lack of monetary demand. This is a long-run problem calling for a long-run solution. The economic process, as Dr. Rao points out, consists of two distinct categories: one in which, given the level of economic development, the economy moves from low employment to full employment; and the other in which it moves from "full employment" at a given level of economic development to "full employment" at the next (higher) level of economic development.¹ It is the latter process that has to be initiated in India.

A solution to short-run unemployment is sought through an increase in investment. One aspect of investment is that it increases demand and income via the operation of the multiplier; the other aspect of investment is that it increases the productive and employment-offering capacity of the economy over a period of time. It is the latter process that can lead to a solution of the long-run problem of under-employment, while the former is important in tackling a fall

¹v. K. R. V. Rao, op. cit., pp. 66-67.

in employment due to a fall in effective demand. That aspect of investment which is ignored in the traditional Keynesian analysis is of great significance in the economics of growth.

2. Counter-Cyclical Fiscal Policy

Even for purposes of a short-run policy of stabilization or anti-depression action in an underdeveloped country, the Keynesian analysis may not be of much use as a theoretical background. It is not meant to imply that the savings-investment approach to the theory of income determination is not necessarily valid for an underdeveloped economy. It may be true that the approach embodied in the Keynesian analysis is the only possible method of analyzing the process of income determination in any country. Actually, this method was employed in the previous section to follow through the effects of deficit spending. But the genesis of booms and depressions, and the nature of the economy are such that the usual Keynesian prescriptions for counteracting cyclical fluctuations are not likely to be of much avail in a typical underdeveloped economy.

Underdeveloped countries are as much subject to economic fluctuations as advanced industrial countries are. But the major fluctuations do not originate in underdeveloped countries themselves. They originate in the more advanced countries and are then transmitted to the less advanced through foreign trade transactions. As is well known, many of the underdeveloped countries are export economies and a substantial part of their national income is derived from the export of a few primary products. In this situation,

the state of foreign demand for exports determines to a large extent the state of the economy. Fluctuations in foreign demand immediately set up inflationary or deflationary movements. Thus a sudden boom in exports, through the operation of the foreign-trade multiplier, leads to a rise in national income and prices; the converse happens when there is a fall in exports.

In the underdeveloped countries investment forms only a small proportion of the gross national product.¹ Fluctuations in private investment cannot therefore affect the level of economic activity to a large extent. Nor is there likely to be a short fall in effective demand due to "over-savings." For these reasons, exports are a more significant determinant of the level of economic activity than investment. Especially in underdeveloped export economies, exports play the same role as investment in more advanced economies in creating instability.

Even where, as in India, exports do not form a very high proportion of total output, external demand seems to exert a preponderant influence on the internal price level. A review of the main inflationary and deflationary movements in India in the last few decades brings out the fact that

¹Also, in some countries, foreign investment plays an important part. For instance, in Ceylon, tea accounted for 42 per cent and rubber 31 per cent of the total value of exports in 1951; in Thailand rice accounted for 63 per cent of the total in 1949; in the Federation of Malaya, rubber accounted for nearly 20 per cent of the net national product in 1948. (UN, Taxes and Fiscal Policy in Under-Developed Countries, op. cit., p. 12.)

the source of the turns in the general economic situation has always been external. We find that "the decline in agricultural prices in the middle and later 'twenties, from the peak touched in 1924-25; the break in prices that occurred at the end of 1929 and the severe depression during the early 'thirties, followed by the slow recovery of prices from 1933 to 1937; the short and sharp recession in 1938... the Korean boom, and gradual return to normalcy--all had a source in some international development."¹ The external factors are superimposed on certain internal factors. The most important internal factor is the supply of agricultural products, especially foodstuffs. A shortage of foodstuffs will tend to raise immediately the general price level.

When depression strikes an underdeveloped country, there is some rise in "open" unemployment, but many of the laborers displaced from shrinking industries tend to get absorbed in agriculture and allied occupations. "The major losses are taken in the form of transfers of workers to less productive enterprise, where they become what Mrs. Robinson has called 'members of the disguised unemployment group.'² Speaking of declines in industrial employment in India, Jathar and Beri say³:

¹Report of the Taxation Enquiry Commission, Government of India, New Delhi, 1955, p. 159. This report is hereinafter referred to as TEC Report.

²Seymour E. Harris, "Some Major Issues" in Economic Problems of Latin America, ed., S. E. Harris, McGraw-Hill Book Co., New York, 1944, pp. 8-9.

³Jathar and Beri, Indian Economics, 9th edition, Oxford University Press, Bombay, 1952, p. 431.

Moreover, unemployment when it does come has not the same terrors for the operatives in India as in the West, owing to the fact that most of our industrial labourers have predominant agricultural interests. Often indeed work in a factory is regarded as a second string to the bow and is taken up only during the slack agricultural season. Industrial unemployment in India differs from the corresponding phenomenon in the West, not only as regards the scale but also as regards the nature of the problem it creates for the State. To a certain extent the problem is automatically solved in India by many of the unemployed returning to their villages.

a. Compensatory Policy in a Depression. In the circumstances described above, the scope for a compensatory policy of deficit-financed public expenditure to counteract a depression is very limited, and such a policy will even run into difficulties. The fall in demand originates abroad and hence stimulating internal demand will in no way help relieve the distress of the export industries. Since in many of these countries the marginal propensity to import is high, an increase in incomes, in all probability, will lead to an increase in imports. With exports already in decline, an increase in imports will mean a deficit in the balance of payments with all the attendant problems. Unless, therefore, a country has considerable reserves of foreign exchange, it is not feasible to pursue this type of compensatory fiscal policy.

Suppose that the country decides to introduce import control in order to forestall the creation of a deficit in the balance of payments. Then the increased demand will be directed towards domestically-produced goods so that unemployment may be reduced to some extent. But there will be a

greater rise in prices than a rise in output and employment, for in predominantly agricultural economies, supply is relatively inelastic. These economies are characterized by institutional rigidities, and the mobility of resources is not great. Moreover, it simply is not possible to get the capital equipment necessary to start new industries overnight. Thus in an underdeveloped economy, injections of purchasing power may dissipate themselves in higher prices of the inelastic domestic supplies. By contrast, in economically developed countries increases in public expenditure readily lead to higher levels of employment and income. For their economies are usually diversified, industrialized, and elastic. Thus we are driven to the conclusion that an effective solution to the problem of instability, to which an underdeveloped economy is subjected owing to fluctuations in international market conditions, lies in the diversification and modernization of the economy. Meanwhile, if an underdeveloped country wishes to follow a policy of compensatory deficit spending, it must take steps to build up in good times sufficient foreign exchange reserves.¹

b. Compensatory Policy in a Boom. A conventional policy of increase in taxation and reduction in public expenditure--surplus budgeting--is likely to be more effective in curbing a boom than the contrary policy in curing a

¹The U. N. Economic Mission to Chile, 1949-50, recommended the creation of such a reserve of foreign exchange. See The Report of the United Nations Economic Mission to Chile: 1949-50, New York, 1951, p. 20.

depression. The effectiveness of this policy is somewhat limited by the fact that progressive direct taxes cover only a small segment of the population. But as the experience of India during the war and its aftermath has shown, the tax system of an underdeveloped country, if suitably adjusted, can have a significant effect in slowing down the pace of inflation.¹

When inflationary conditions are initiated specifically by a sudden spurt in exports, manipulation of export duties will be more effective than raising the level of taxes in general. Experience has revealed export duties to be a fairly effective anti-inflationary weapon in underdeveloped countries. Increases in export taxes and manipulation of exchange rates were used by many primary producing countries during the Korean boom to siphon off some of the windfall gains of the export sector and to impound a large amount of foreign exchange. In India export duties have been used in recent years as a stabilizing device. To give one instance, following the devaluation of the rupee in September 1949, the export duty on jute hessians was raised from Rs 80 to Rs 350 per ton; again, after the Korean War broke out, the duty was raised to Rs 750 on October 21, 1950, and further to Rs 1500 on November 20, 1950.² Other export duties also were raised, and new ones were imposed. Later when the export boom levelled off and there was a slack in

¹TEC Report, Vol. I, p. 161.

²R. N. Bhargava, The Theory and Working of Union Finance in India, George Allen and Unwin, London, 1956, p. 208.

the international market, many export duties were reduced and some were abolished. These adjustments in export taxes enabled the government to even out fluctuations in prices and, to some extent, curb inflationary tendencies originating in the export sector.

The use of export duties as a counter-cyclical or stabilizing measure, however, introduces a great element of instability in the finances of the government. The revenue from export duties itself fluctuates with the volume and price of exports; if rates also are changed, the fluctuations are much greater. When demand and prices are high, the rates are increased; the revenue then increases more than in proportion to the volume and value of exports. The reverse is true in the case of a fall in demand; the revenue from export duties falls more than proportionately. The fluctuations in governmental revenues are rendered still greater because of the effect of the fluctuations in exports on the volume of imports. When the demand for exports is high, the volume of imports also is high because of the greater availability of foreign exchange; import duties then bring in correspondingly greater revenue. When the demand for exports falls, there is a stringency in the foreign-exchange market, import restrictions are tightened, and there is a corresponding fall in the revenue from import duties. This is true of most of the countries of the ECAFE region.¹

¹Economic Bulletin for Asia and the Far East, Vol. IV, No. 3, November 1953, p. 4.

Instability in governmental revenues may become highly embarrassing in economies with an inflationary bias, such as are many of the underdeveloped countries undertaking ambitious schemes of economic development. Moreover, an extensive use of export taxes may interfere with an optimum pattern of world trade; and they are less equitable than the income tax in so far as they do not discriminate between small and large producers.

It seems reasonable to conclude from the above analysis that, ultimately, the way to reduce the exposure of underdeveloped countries to the ebbs and flows of world markets lies along the path of diversification and balanced economic development. Therefore, a fiscal policy that facilitates capital formation serves at the same time to reduce instability. The fiscal structure of an underdeveloped country, first and foremost, has to be geared to the requirements of rapid economic growth.

B. The Requirements and Pattern of Economic Growth

If it is accepted that fiscal policy in underdeveloped countries must be geared primarily to the requirements of rapid economic growth, what of the details of such a policy? Before proceeding with the details, it might be useful to restate the essential requirements of economic growth. No one has come up with a full-fledged explanation of why some countries, in the course of history, suddenly lifted themselves out of the mire of poverty and proceeded along the path of rapid economic growth, while many others lagged far

behind. Nevertheless, an analysis of the history of economic development in the now advanced countries suggest at least the essential causes or requirements of economic growth. As Professor W. A. Lewis puts it,¹ the proximate causes of economic growth are the effort to economize, the accumulation of knowledge and its application, and the accumulation of capital. These causes, though distinguishable conceptually, usually develop and grow together in any society.

1. The Key Role of Capital Formation

Although it is true that all the above-mentioned three requirements must be met if economic growth is to take place, it seems unquestionable that capital accumulation is the most important limiting factor in the underdeveloped countries of the present day. In the view of many economists, capital occupies the central and strategic position in the process of Economic development.² It could, of course, be argued that without the presence of other factors favorable to development, the supply or creation of capital would be of no avail. Indeed it often has been argued that economic development is a matter of changing social attitudes and economic institutions rather than a simple process of increasing the capital per head. Yet the history of economic development

¹W. A. Lewis, The Theory of Economic Growth, Richard D. Irwin, Inc., Homewood, Ill., 1955, p. 11.

²See, for example, Walter Heller, "Fiscal Policies for Under-Developed Economies," op. cit., p. 2; M. Abramowitz, "Economics of Growth," in A Survey of Contemporary Economics, Vol. II, ed., G. Haley, Richard D. Irwin, Inc., Homewood, Ill., 1952, p. 146; and N. S. Buchanan and H. S. Ellis, Approaches to Economic Development, The Twentieth Century Fund, Inc., New York, 1955, p. 67.

shows that widespread changes in attitudes, values, and institutions came about in the very process of economic development, and not prior to all development. What is required as a pre-condition of growth is rather the existence of some group or groups of people who are interested in economic development, who have "the will to economize," and who are anxious to work for material rewards. If such groups become dominant in a society, they gradually change the economic and political institutions in ways favorable to development, and their more "rational" attitudes spread to other sections of the population. Where such groups do not at all exist, or, if existing, do not have the power or knowledge to initiate changes, economic development may be retarded seriously.

In most of the countries of Southern Asia, the governments have shown a vital interest in economic development and have initiated ambitious programs of improving agriculture and building up industry. These governments can ignore or neglect economic development only at their peril. Many important steps have been taken to promote development and to initiate institutional changes that will make the climate more favorable to growth. In this setting, capital seems to be the greatest bottleneck. The present study concentrates on this key-factor in economic development and seeks to discover the institutional changes needed in one important area, namely, the area of governmental finances, in order to accelerate the process of capital formation.

Given the will to economize on the part of some important segments of the population, the whole process of eco-

economic development turns around the possibility of achieving a much higher rate of capital formation than exists at present in most of the underdeveloped countries. As we have seen earlier, communities in which per capita income is increasing only very slowly invest only 5 to 6 per cent of their national incomes, while progressive economies invest 12 per cent per annum or more. Probably the most important task involved in economic development is to convert an economy from a 5 per cent to 12 per cent saver--with all the concomitant changes in attitudes and institutions. Given the will, this higher rate of saving and investment is not impossible of achievement in the underdeveloped nations. "No nation is so poor," W. A. Lewis aptly points out, "that it could not save 12 per cent of its national income if it wanted to; poverty has never prevented nations from launching upon wars, or from wasting their substance in other ways."¹

Some estimates that have been made of the capital needs of underdeveloped countries to bring about industrialization serve to bring out clearly the high priority that has to be assigned to the process of capital accumulation in these countries. In 1950 Colin Clark made some calculations of capital needs for China, India, and Pakistan. According to his calculations, India and Pakistan need savings at the rate of 12.5 per cent of national income in order to absorb the increasing labor force and maintain the past rate of increase in productivity.²

¹W. A. Lewis, op. cit., p. 236.

²Fortune, July 1950, pp. 90-91.

As against this requirement the actual saving amounted only to about 7 per cent of national income in 1955-56.

An FAO calculation based on certain assumptions indicated that for a population of 100 million people, annual investment of about \$920 million would be required to achieve some degree of industrialization.¹ More specifically, this sum would be required to move 1 per cent of the farm population into non-farm occupations.² This would mean that India, with a population of 370 million, would need an annual investment of the order of \$3404 million to carry through the limited program of economic development suggested above. In point of fact, however, net investment amounted only to Rs 7.9 billion in 1955-56.³

These estimates, albeit rough and subject to error, give us an idea of the enormously high cost involved in carrying through a modest program of industrialization. To some extent domestic resources could be supplemented by external resources. But there is no indication that external finance is going to be available to the countries of the ECAFE region on any significant scale. The aggregate national income of ECAFE countries, excluding China and Japan, probably was about \$50 billion in 1950. Foreign aid and investment equal to 1

¹Mentioned in Economic Bulletin for Asia and Far East, Vol. I, No. 1, August 1950, p. 21.

²This estimate is based on the assumptions that 40 per cent of the population is in the labor force; that 80 per cent of the labor force is engaged in rural occupations; that population increases at the rate of 1.5 per cent per annum; and that capital investment of \$1000 is required per person.

³This is the equivalent of \$1.66 billion.

per cent of this would be \$500 million. The amount of annual foreign investment and aid currently available does not amount even to this figure. The conclusion is inescapable that domestic capital formation has to be stepped up greatly, if any economic development is to take place in terms of industrialization and of raising per capita incomes in this depressed region of the world. Accordingly, the highest priority has to be assigned to the process of capital accumulation. Neglecting to do this, the people of this region will forfeit all chances of economic progress.

2. The Pattern of Investment

The question of investment has been discussed so far in macro-economic terms, and the need to raise the rate of aggregate net investment has been stressed. It is obvious, however, that the pattern or composition of investment is no less an important determinant of the rate of growth. It may be proper to concentrate on aggregate investment when dealing with cyclical fluctuations; for we are then concerned with the level of investment that would lead to the desired level of income. But when dealing with economic development, it is necessary to look into the composition of investment as well. In so far as the existing pattern of investment differs from the optimum pattern, it becomes the responsibility of the state to undertake or promote investment along lines most beneficial to society.

The optimum pattern of investment for an underdeveloped country will depend, among other things, on the fruitful lines of development open to the country concerned, and on

the social marginal productivity of different lines of investment. It may be useful to say a few words on each of these criteria for determining the composition of investment.

a. Balanced Growth. The early post-war view on the economic development of underdeveloped countries, among western economists at any rate, seems to have been that their salvation lay primarily in the improvement of agriculture and other sectors of primary production. More recently, opinion has veered round to the point of view that, in many cases, the most fruitful line of advance lies along the path of a balanced development of agriculture and industry.¹ This is particularly applicable to a country like India which is overpopulated, and which is experiencing a steadily mounting pressure of population on land. Already there exists a good deal of disguised unemployment and it is likely to grow with increases in population. Therefore, a rapid growth in non-farm occupations becomes an obvious necessity, if India is to draw the surplus man power off the land and at the same time provide employment to the additional laborers entering the working force every year. This is not to deny the importance of raising the productivity of the agricultural sector. A growing industrial sector needs more and more raw materials, and the increasing number of industrial workers have to be fed. Failure to improve agriculture, therefore, will inhibit the growth of the in-

¹Not all countries, of course, need to be, or could become, predominantly industrial economies.

dustrial sector.¹

Here lies one of the trickiest problems in economic development. It is no easy matter to create an increasing "surplus" in agriculture and transfer the whole or part of it to the industrial sector. Much of the food, especially in the early stages, will be needed to feed the workers in the investment sector who cannot immediately furnish the farmers with consumer goods in exchange. This means that the agricultural sector would have to save a part of its increasing product. If this is not done voluntarily, suitable tax measures have to be devised to force this "saving" out of the agricultural sector. Taxation of agriculture then must be viewed in this light.

b. Economic and Social Overheads. It was pointed out in an earlier section (Part I, Section B) that in underdeveloped countries the inducement to invest is rather low, because of low incomes and small size of the market. One way to break out of the vicious circle on the demand side is to take steps to raise the marginal productivity of private investment. Any investment that creates "external economies" without counter-effects on internal economies will help achieve this objective. These external economies may take the form of enlarging the size of the market or of reducing costs of production. The most important external economies that arise in the earlier stages of economic development relate not to

¹One alternative is to import food in exchange for exports of manufactures.

particular firms and industries but to the economy as a whole. The external economies traditionally discussed by economists arise from the enlargement of the size of a particular industry. After an industry has grown to a certain size, it is able to take advantage of many specialized services, such as a pool of technical skill, a common source of raw materials, transportation facilities, credit facilities, and so on. But a more important type of external economies arise from the establishment of economic and social overhead capital which can be more fully utilized by a growing economy. The economic overheads consist of such investments of capital as highways, railroads, communications, power installations, ports, and technical training facilities; the social overheads consist of schools, hospitals, libraries, and public health measures. It is clear that in underdeveloped countries these categories of investment can widen the market, or raise the productivity of labor, or reduce costs of production in several sectors of the economy. Once these facilities are established, new industries can, up to a point, take them for granted.

Dr. John H. Adler has expressed the opinion that the differences in the economic development of different countries can be explained partly by the fact that in some countries external economies materialized, while in others they did not.¹

¹J. H. Adler, "The Fiscal and Monetary Implementation of Development Programs," American Economic Review, Papers and Proceedings, May, 1952, p. 587.

As to why in some countries these economies did not arise, he says:

It may well be that the colonial status in which the underdeveloped countries found themselves a hundred and fifty years ago may have something to do with the differential rate of the evolution of external economies. These countries depended for their organizational social overhead, particularly in marketing and transportation, on their respective mother countries.¹

Mr. Adler's view corroborates the opinion widely held in many underdeveloped countries that one of the most harmful results of colonialism was the lop-sided development of their economies. Even where some economic overheads were developed, say, in the form of transportation facilities, they were designed primarily to serve the narrow export sector. In recent years the governments of various underdeveloped countries have taken many steps to redress the balance.

In any development program, high priority has to be assigned to the creation of overhead capital. But this requires huge expenditures of funds the returns for which may be neither quick nor direct. (Moreover, private capitalists in underdeveloped countries cannot command the enormous sums needed for such investment. It is, therefore, necessary for the government to bear the major part of the financial burden of the expenditures for economic and social overheads. In other words, a good deal of public investment in the initial stages of development has to take the form of overhead capital.

¹Ibid., pp. 587-88.

In addition to the direct undertaking of investment, the state also can influence the pattern of private investment. Western observers are unanimous in complaining about the "unproductive" nature of a great part of private investment in underdeveloped countries. Entrepreneurs in these areas are attracted unduly towards quick returns and speculative gains. Commerce and trade claim too large a share of total capital invested and increments thereto. Real estate, urban construction, luxury buildings--all these are favorite forms of investment, with the result that agriculture and manufacturing industry are starved of capital. While it is true that in some underdeveloped countries like India, enterprising capitalists are showing an increasing interest in manufacturing, the fact remains that a good deal of investment is directed into relatively unproductive channels. One important task of public policy then is to alter the pattern of investment. At the least, fiscal policy could be used to encourage some forms of investment and discourage others; at the most, where national planning is adopted, it could be used to reorient the pattern of investment in accordance with the priorities laid down in the plan.

From what has been said in this section, the following corollaries can be drawn: (a) the greater part of public investment, in the early stages, will have to be devoted to the provision of overhead capital; (b) much of this investment may not be directly remunerative, while some of it like electric power plants may bring a direct return; (c) hence both taxes and loans can be used to finance public invest-

ment; (d) the raison d'etre of investing in social overhead capital is to raise the marginal productivity of private investment; (e) therefore, steps must be taken simultaneously to promote private investment in directions most beneficial to society. The implications of these statements for tax policy will be spelled out in Part III.

C. The Goal of Fiscal Policy in Developed and Underdeveloped Economies

The central idea of this thesis is that the primary task of fiscal policy in underdeveloped countries is to raise the ratio of savings to national income. The need for a higher rate of savings than exists at present has been amply demonstrated above.¹ The need is much more urgent than is generally recognized by policy makers in these countries. And there is reason to believe that well-devised policy measures can succeed in making available a larger flow of resources for economic development. This means that the role of fiscal policy in underdeveloped countries essentially has to be allocative. It is concerned with allocating more resources for investment and restraining consumption. By contrast, fiscal policy in developed economies is concerned mainly with regulating the total flow of purchasing power, with determining the level of total effective demand. Speaking of the United States, Arthur Smithies says: "Fiscal policy aims primarily at controlling aggregate demand and leaves to private enter-

¹Part II, B.

prise its traditional field--the allocation of resources among alternative uses." It is obvious that in an underdeveloped country the emphasis has to be on allocation, that is, the broad allocation as between consumption and investment, and as between different forms of investment. True, in a developed economy too, under certain circumstances, the rate of investment might have to be changed by public policy. But in the conditions prevailing in the developed economies at the present stage of their development, maintenance of stability--short-run and long-run--remains the key-note of fiscal policy, whereas in the underdeveloped countries the key-note of policy must be acceleration of the rate of growth.

1. The Concept of Functional Finance

As recently as 30 years ago, there was no concept of fiscal policy in the modern sense of the term. This was only natural because the relation of governmental financial operations to the working of the national economy was less clearly understood, and government was on a relatively smaller scale. The theory of public finance treated the government as one financial unit among several other units in the economy, each of which received income and incurred expenditure. Public finances were to be conducted on essentially the same basis as private finances. In this view, public expenditure connoted collective consumption, and public revenue the cost thereof. From the economic point of view then, the chief problem in public finance was to apply the general rule of maximizing satisfactions. On the revenue side, the pre-

occupation was with finding the most equitable way of raising the needed revenue; on the expenditure side, the inquiry was concerned with what were the desirable forms of expenditure and how far expenditure should be pushed in each direction. Since the government was treated on the same basis as a private economic unit, it was held strongly that the government "should pay its way" just like an individual or firm. Moreover, on the classical assumption of full employment, creating a deficit in the budget or increasing the deficit could lead only to inflation. One of the cardinal principles of pre-Keynesian public finance, therefore, was that the budget always should be balanced. The more important concept, and one which furnished the real basis for the whole theory of public finance, was that public expenditure was required only to secure the collective consumption of certain goods and services, and that taxation was a contribution to defray the costs incurred for this purpose.

The theory of national income and employment, originally developed by Keynes, revolutionized the whole basis of public finance, and rendered some of the old concepts well-nigh obsolete. His theory shed new light on the relation of government finances to the level of income and employment in the economy. It was realized then that government finances could be manipulated to influence the level of economic activity, by influencing the level of effective demand. This is the genesis of the modern concept of fiscal policy in advanced economies. Its underlying notion is that the revenue and expenditure programs of the government would be so adjusted

as to produce and maintain a stable and high level of economic activity.

Two important implications of this concept of fiscal policy are worthy of note here. First, the finances of the government should be conducted on a "functional" basis, and revenues and expenditures should not be considered as being occasioned solely by the requirement of securing collective consumption. This view of public finance may be called "functional finance" (to use Mr. Lerner's phrase). Secondly, the budget need not always be balanced. Under conditions of less than full employment, for instance, a deficit would be desirable.

The latter implication is the more dramatic of the two, and usually is pointed out as the most significant aspect of the change that has occurred in the theory of public finance. Actually, however, it is the concept of functional finance which constitutes the real revolution in point of view. If the government's expenditure and tax programs are to be treated on a functional basis, the simple analogy with private finance no longer holds good. Expenditure may be incurred not mainly for the sake of its direct benefit, but for the sake of the indirect effect it produces in the form of a rise in employment; and revenue may be raised not to meet a proposed expenditure, but to curtail effective demand. It follows that taxation no longer can be looked upon merely as a means of finding the money for the state; it becomes one of the primary weapons in the hands of the government to promote stability and progress. The primary purpose of

taxation in an advanced economy "is to restrict private spending to the point where it no longer exceeds the amount which, given the claims of the State, can be made available-- in other words to ensure that the total of public and private spending is adequate, and no more than adequate to secure the full utilization of economic resources."¹ To put it in a different way, the primary role of taxation in an advanced economy is not to avoid deficits but to avoid inflation.

In the early Keynesian era, the preoccupation was with the problem of short-run economic stability and with counteracting cyclical fluctuations. Attention was given mainly to the perfecting of a counter-cyclical policy. Pressing short-run problems--the depression of the 'thirties and the inflation of the war and post-war years--absorbed all attention, to the neglect of the long-run problems of growth. More recently, however, conditions for long-run equilibrium in a dynamic economy have been analyzed, and the possibility of the emergence of long-run disequilibria has been pointed out, calling for a shift in emphasis in the goal of fiscal policy. The goal postulated now is that of insuring conditions of stable growth. /As fiscal policy in underdeveloped economies has to be tailored to the needs of rapid economic growth, it is in the context of the problems of growth that the differences in the objectives of fiscal policy in developed and underdeveloped countries can most profitably be discussed.

¹N. Kaldor, An Expenditure Tax, George Allen Unwin Ltd., London, 1955, p. 174.

2. The Requirements of Steady Growth

Mr. Harrod and Professor Domar have been in the forefront of the economists who have tried to study the requirements of steady growth in an economy.¹ They are both interested in discovering what rate of income growth will keep a dynamic economy in the path of equilibrium from year to year. Although their models of steady growth differ in details, they are similar in substance. In this section we shall touch upon their theories only to the extent necessary to derive the parameters for a realistic fiscal policy.

Harrod and Domar assign to investment a crucial part in the process of growth. They emphasize that investment has a dual character: on the one hand, investment creates income; on the other, it augments the economy's productive capacity by enlarging its capital stock. The Keynesian analysis assumed that the stock of capital was given² and discussed the income-creating effects of investment. This assumption may be valid for an analysis of essentially short-run problems. But when we turn our attention to the long-run, we must take into account the fact that net investment adds to

¹R. F. Harrod, "An Essay in Dynamic Theory," Economic Journal, Vol. XLIX, No. 193, March 1939, pp. 14-33; Towards a Dynamic Economics, MacMillan and Co. Ltd., London, 1948; "Supplement on Dynamic Theory," Economic Essays, MacMillan and Co. Ltd., London, 1952. Evsey Domar, "Expansion and Employment," American Economic Review, Vol. XXXVII, No. 1, March 1947; "Capital Expansion, Rate of Growth and Employment," Econometrica, Vol. XIV, No. 2, April 1946; and other essays by the same author which, along with the above-mentioned two, have been reproduced in his Essays in the Theory of Economic Growth, Oxford University Press, New York, 1957.

²J. M. Keynes, General Theory, p. 245.

the productive capacity of the economy. Hence, so long as there is net investment, this capacity will keep growing. This being so, unless real income and output also expand and do so at a rate proportionate to that at which productive capacity of the stock of capital is expanding, excess or idle capacity necessarily will lead entrepreneurs to cut back investment outlays, with the resultant fall in incomes and employment in subsequent periods. This means that the economy moves off the equilibrium path of steady growth. Thus, in a long-run sense, employment is a function of the rate of growth of investment and income.

If long-run disequilibrium and unemployment are to be avoided, then, income must grow at a rate just sufficient to insure the full-capacity use of a growing capital stock. This "required" rate of growth of income may be called the full-capacity rate of growth.

In the Harroddian model, this rate of growth is given by the equation $G_w = \frac{s}{C_r}$, where G_w is the "warranted rate of growth," s is the proportion of income that is saved (S/Y), and C_r is the value of capital required to produce a unit increment of output.¹ G_w , the warranted rate of growth, corresponds to what has been called above the full-capacity growth rate. The equation, therefore, states that if full and continued utilization of capacity is to be insured, income must grow at the annual rate of $\frac{s}{C_r}$.

¹R. F. Harrod, Towards a Dynamic Economics, MacMillan and Co. Ltd., New York, 1956, p. 81.

The requirement for a continued full-capacity income may be written also as follows:

$$Y_t + 1 - Y_t = osY_t^1$$

That is to say, national income in year $t + 1$ must exceed that of year t by the amount of added productive capacity which is equal to osY_t , where o is the reciprocal of the accelerator coefficient,² and s is equal to the average $\bar{s}$ the marginal propensity to save. The term os corresponds to $\frac{s}{C_r}$ in Harrod's equation.³

On the assumption that the average propensity to save is constant (and hence $\bar{s}$ to the marginal propensity to save), it can be shown that the rate of growth of investment must equal the rate of growth of income.⁴ Thus, given the productivity ratio and the propensity to save, income and investment must grow at a constant geometric, or exponential, rate of os per year in order to insure the full utilization of the annual additions to the community's productive capacity. Thus, os is G_w , or the full-capacity rate of growth. The

¹D. Hamberg, Economic Growth and Instability, W. W. Norton Company, Inc., New York, 1956, p. 29.

²There is some question whether we should take the value of the marginal capital coefficient or the accelerator coefficient. Professor Hamberg feels that "in an enquiry into the rate of income growth 'required' to absorb into production a growing stock of capital, it is necessary to limit our attention to increases in productive capacity that are the result of induced investment only." (Ibid., p. 42.) Hence o is taken to stand for the reciprocal of the accelerator coefficient.

³The corresponding term in the Domar Model is $\alpha\sigma$ from his equation $\frac{\Delta I}{I} = \alpha\sigma$ ("Expansion and Employment" in Essays in the Theory of Economic Growth, p. 91).

⁴D. Hamberg, op. cit., p. 30. The mathematical derivations of the propositions of the various models given here are omitted, since they are not germane to our purpose.

actual rate of growth may be designated by G . If then $G = G_w$, we may say that there is equilibrium growth.

3. The Genesis of Long-Run Disequilibria

Disequilibrium will arise in the economy if G and G_w are not equal. If $G > G_w$, there arise conditions of secular inflation. This is because income grows at a rate faster than what is allowed by the growth in capacity, leading to a deficiency of capital goods and increasing pressure on capacity. Under these conditions, desired investment would be greater than desired saving, and production would fall short of aggregate demand. Secular inflation is the result. If on the other hand, $G < G_w$, then there arises excess capacity, and hence fall in investment. The end result is fall in employment and income. This may be called a condition of secular depression.

It would follow that one of the tasks of public policy designed to maintain long-run stability is to bring G and G_w together. If G is made equal to G_w , full utilization of capacity will be insured. However, though $G = G_w$ is a necessary condition of long-run equilibrium, it is not a sufficient condition. We have to introduce another growth rate to state the full-conditions required for dynamic equilibrium. This is the full-employment rate of growth, which is designated by G_n . This is the rate of growth of output which will insure full employment to a growing labor force in the context of rising productivity of labor. If $\underline{n}$ is the (annual) rate of growth of the labor force, and $\underline{h}$ is the rate of growth of

labor productivity, then $G_n = \underline{n} + \underline{h}$.¹ Now if $G_n = G_w = G$, we may say that there is equilibrium full-employment growth.² But the moving equilibrium with full employment will be rudely disturbed if G_w diverges from G_n .

If $G_n > G_w$, conditions of secular inflation would tend to be generated, though, paradoxically, unemployment would grow side by side. Inflation would be caused by the fact that G , unless regulated by the government, would tend to reach G_n , and therefore would lie between G_n and G_w . Unemployment is the obvious result of the fact that the rate of growth of capacity is insufficient to afford full employment to the growing labor force.

The opposite result would follow, if $G_n < G_w$. Conditions of secular stagnation would be generated. This is because G cannot rise above G_n for an extended period of time, and therefore would lie below G_w . Thus, though labor shortage might arise at first, excess capacity would emerge in course of time, and would bring about unemployment and depression.

4. Implications for Long-Run Fiscal Policy

a. Developed Economies. In the light of the discussion contained in the foregoing pages, the requirements of fiscal

¹Kenneth T. Kurihara, "The Fiscal Role of Government in Economic Development," Indian Economic Journal, Vol. XXXVII, July 1956, p. 40. This formula is valid only for the short-run. For a longer period the rates would have to be compounded.

²Arthur Smithies, "The Control of Inflation," The Review of Economics and Statistics, Vol. XXXIX, No. 3, August 1957, p. 273.

policy in a developed economy may be set forth briefly. If at any given time there is disequilibrium in the economy, this may be the result of the interplay of short-term and long-term factors. Public policy must be directed first to rectifying the maladjustment in the long-term factors, and then to tackling the short-run causes of disequilibrium. We are here concerned with the former.

In a developed economy, it is conceivable that G_w might exceed G_n or be less than G_n . In either case, the aim would be to bring them and G together, and maintain conditions of stable growth. Since the per capita income already is fairly high and since, under conditions of stability, the rate of growth of output is fairly satisfactory, the emphasis on stability is warranted. The maintenance of stability or stable conditions of growth may at times require the diversion of resources from investment to consumption. For in a developed economy G_w can exceed G_n and G . This spells secular depression. The remedy would be to lower G_w which, as we have seen, is equal to $\underline{os}$. The condition of too high a G_w arises in a developed economy because $\underline{s}$ (S/Y) is high. The requirement of stability thus would call for measures designed to reduce the ratio of savings to national income.¹ The contrary policy of curtailing consumption would be called for in the event that $G_n > G_w$. Thus in a developed economy,

¹Arthur Smithies discusses a similar case in which $G = G_w > G_n$. His recommendation in this instance is that investment must be deterred, and private consumption or government expenditure encouraged. ("The Control of Inflation," op. cit., p. 278.)

$\underline{s}$ has to be moved up or down according to circumstances.

b. Underdeveloped Economies. Herein lies the difference between the requirements of fiscal policy in developed and underdeveloped economies. In the latter, conditions are not conceivable in the near future which would require a lowering of $\underline{s}$. The vast majority of people in these areas are living on the margin of subsistence, so that the marginal propensity to consume is very high. Therefore, supported by a rising consumption demand, output can be expected to grow at a rate sufficient to insure full utilization of capacity. The problem rather is to raise G_w so that the backlog of under-employment may be liquidated.

In underdeveloped economies G_w chronically falls short of G_n . In fact this condition has persisted for such a long while that a huge volume of under-employment has emerged in the economy. Currently, the rate of investment is too low to afford full employment even to the existing labor force, let alone the annual additions made to it through increases in population. As $G_n > G_w$, there is not only disguised unemployment, but also conditions of chronic secular inflation. In a sense, inflation is merely a reflection of the attempts made by the economy (through governmental action or otherwise) to attain to a high rate of growth of output which pushes G above G_w .

Public policy must be designed to solve these twin problems of under-employment and inflation. In this context the goal of fiscal policy in an underdeveloped country may be said to be the promotion of the highest possible rate of

capital formation without inflation. Stability is necessary for progress, but the maintenance of stability does not require a fall in s as may happen in a developed economy, but a rise in it. Since the basic malady is that G_n exceeds G_w , raising the proportion of savings to income will enable the economy at the same time to reduce unemployment and maintain stability. So long as it is intended to raise the percentage of total income going into savings, as income increases, it is necessary to keep the marginal propensity to save above the average propensity.

It was noted that in a developed economy G_w might rise above G and/or G_n . This condition clearly cannot emerge in an underdeveloped economy so long as there is disguised unemployment and the standard of living is so deplorably low. At the present stage of development public policy would not be called upon to rectify a situation in which there is a shortage of labor or a short fall in consumption demand. This means fiscal policy can remain geared to one direction, instead of having to be switched backwards and forwards as may happen in a developed economy.

The contention put forward is that as in a developed economy, so in an underdeveloped economy too, public finances should be conducted on a functional basis; but that the most important function to be performed is the raising of the rate of savings and investment, and not the mere avoidance of inflation. That this should be one of the primary goals of public policy in an underdeveloped economy will be granted readily nowadays. What is not so readily granted, or even

understood, is the implications of this approach in the several fields of public finance. When one postulates an objective for fiscal operations other than the securing of the "collective" consumption of certain goods and services, one, by implication at least, adopts the functional finance approach. But while the approach is changed, principles and canons appropriate to an older approach are left to rule the field. This is true especially in the field of taxation, to which we shall turn in the next part of this study. Meanwhile, let us summarize the objectives of fiscal policy.

5. Objectives of Tax and Fiscal Policies Restated ✓

On the basis of the discussion of fiscal policy contained in the foregoing pages and in the light of the currently accepted social goal of an equitable distribution of the national product, the main objectives that should govern tax and budgetary policy in a country such as India may be stated as follows:

- (a) increasing the rate of investment by checking actual and potential consumption;
- (b) encouraging the flow of investment into channels judged to be most desirable from the point of view of society;
- (c) in a quasi-planned economy, regulating the flow of purchasing power in accordance with the overall pattern laid down in the plan;
- (d) where large inequalities of income and of wealth exist, modifying the distribution of income and wealth in a manner and to the extent that are consistent

with the best long-term interests of the population as a whole.

The first objective relates to increasing the overall flow of resources into investment. Over a period of time this is achieved by raising the incremental saving ratio. The second relates to the socially optimum pattern of investment. The third objective is relevant where the quantum as well as the pattern of investment is centrally planned to some extent. In this case fiscal policy becomes an adjunct to investment policy.

The fulfillment of all these three objectives will lead to a rise in the national product. The fourth objective relates to the distribution of the rising national product. It is needless to canvass the importance of distributional considerations. A mere increase in per capita income does not necessarily lead to an increase in the welfare of all sections of the people, unless an equitable distribution of the rising national product is assured. An equitable distribution is usually taken to mean a reduction in the existing inequalities of income and wealth. To what extent inequalities should be reduced is partly a matter of value judgement, partly a matter of the economic system that is adopted, and partly a matter of incentives within that system. These matters will be discussed when direct taxation is taken up for consideration. It suffices to say now that reduction of inequalities rates high in the scheme of social values in the countries of Southern Asia. Policies that do not take any note of this objective are unlikely to be acceptable

to the broad masses of the people in these countries. Therefore, while it is easy to agree with Nurkes that "Not a change in the inter-personal income distribution but an increase in the proportion of national income devoted to capital formation is the primary aim of public finance in the context of economic development,"¹ it is not so easy to agree that " ... using taxation as a means of mitigating the inequalities of wealth--a revolutionary and essentially socialist idea--appears rather old-fashioned now and in any case beside the point."² Neither of the two objectives can be neglected. This is not merely because of political reasons, but also because the two objectives are closely inter-related. If the inter-relationship is properly understood, a satisfactory reconciliation of the objectives is not impossible of achievement.³

Fiscal policy can seek to influence the economy, on the one hand, by the amount of public income that is raised, and on the other, by the amount and direction of public expenditure. The three important fiscal means by which resources can be raised for the public exchequer are: taxation, borrowing from the public (other than commercial banks), and credit creation. These means must be used in

¹Ragnar Nurkse, Problems of Capital Formation in Underdeveloped Countries, p. 147.

²Ibid.

³It is not true that all measures of re-distribution will reduce incentives in the economy as a whole. Some measures will increase the incentives of the lower-income groups more than they reduce the incentives of the higher-income groups. Further, incentive to work is as important as incentive to save. To strengthen the former a proper wage policy is called for.

harmonious combination so as to produce the best overall effects in terms of economic progress with stability.

Of these three means, it is obviously taxation that is the most important. If wisely conceived and skillfully used, it can become a very effective instrument of policy. As part of a general program of development taxation may be used to accomplish the following objectives:

- (a) restraining or curtailing consumption and thus transferring resources from consumption to investment;
- (b) increasing the incentive to save and invest;
- (c) transferring resources from the hands of the public to the hands of the state to make possible public investment;
- (d) modifying the pattern of investment;
- (e) mitigating economic inequalities.

All these objectives, it will be seen, are related to the ultimate goals of rapid increase in national income and of improvement in its distribution. The problem is to design a structure of taxation that will be conducive to the accomplishment of these objectives.

III. STRUCTURE OF TAXATION MOST APPROPRIATE FOR INDIA

A. Functional Finance and Taxation

The structure of public finance in many underdeveloped countries including India has grown up haphazardly, influenced by historical accidents, the example of other countries, the thinking of foreign rulers, and the exigencies of the moment. Though many "productive" sources of revenue may have been tapped, the systems of taxation generally have not been built on sound principles suited to the requirements of rapid economic growth. A rational re-organization of the structure of taxation, in the light of the objectives discussed in Part II, will not only be conducive to rapid economic growth, but it will also make it possible to raise more revenue in the long run. As Buchanan and Ellis point out: "While neither ideal equity nor optimum yield may be expected of the tax systems in many countries, the improvement of revenue systems throughout the underdeveloped world offers one of the greatest unexploited instruments of economic progress."¹

The basis of re-organization of the tax system must be the concept of functional finance. But, as indicated earlier, the function to be performed is significantly different from that originally envisaged by the Keynesians. The functional financiers of the west consider that the primary purpose of taxation is the avoidance of inflation. The mere avoidance of inflation, however, does not insure rapid growth

¹Norman S. Buchanan and Howard S. Ellis, Approaches to Economic Development, p. 18.

in an underdeveloped country. If we confine public policy to the avoidance of inflation, we may help perpetuate the state of "underdevelopment equilibrium." Though avoidance of inflation is necessary, the more important goal is to raise the proportion of national income going into capital formation. To put it in a different way, inflation is to be avoided not by cutting down investment, but rather by raising the rate of savings so that a high rate of investment may be sustained without undermining stability. Taxation therefore is to be looked upon as a powerful tool in the hands of the government for raising the ratio of savings to national income.

1. Recent Trends in Thinking

The role of taxation in raising the resources needed for economic development is recognized by many writers in the field. The trend of opinion, however, seems to be in favor of insuring collective compulsory saving through taxation. Mr. Heller says: "To break out of this [vicious] circle, apart from foreign aid, calls for vigorous taxation and government development programs; on this point, expert opinion is nearing a consensus."¹ This consensus in favor of collective saving means that emphasis is placed on stepping up public investment and financing it through higher taxation. The case for tax-financed public investment generally is built on the following arguments.²

¹Taxes and Fiscal Policy in Under-Developed Countries, p. 3.

²See, for example, "Taxation and Economic Development in Asian Countries," Economic Bulletin for Asia and the Far East, Vol. IV, No. 3, November 1953.

A primary cause of low investment is the low level of domestic savings. Personal savings in the countries of South Asia are estimated to stand between 1 and 2 per cent of national income. Business savings also are not very large. Small businesses predominate and large-scale corporate enterprises, which can be expected to generate a sizeable volume of savings, cover only a small part of the economy. Therefore, the needed scale of private savings and investment is not forthcoming. It is further argued that what little investment one finds is often directed into unproductive channels. Business savings frequently are not invested in agriculture, transport, and industry. They are used for speculative purposes and for investments in commerce and real estate. The inference is drawn that public investment has to be stepped up even at the expense of private investment. For example, the Economic Bulletin for Asia and the Far East makes this statement: "Taxation, therefore, remains as the only effective financial instrument for reducing private consumption and investment and transferring resources to the government for economic development."¹

Another powerful argument is adduced in favor of public investment and compulsory savings. Most of the Asian countries seem to set a great score on reducing inequalities of income and wealth. But if the economy is to rely primarily on private investment, inequalities will not be

¹Ibid., p. 3.

reduced, but even may be increased. For private capital formation necessitates the building up of private fortunes; "... this way of building up the capital of a country has always given rise to great political offence. The only feasible alternative is to build up capital on public account."¹ In this view, taxation could be used to reduce inequalities as well as to promote public investment. What is needed then is a higher level of taxation on all sections of the population and a tax system which is more progressive with respect to income and wealth. Two main ideas on the subject of public finance current in India, for instance, are reduction of inequalities and insuring collective savings through taxation. Indeed they are very near becoming articles of faith. To be sure, the adverse effects of highly progressive taxation often are referred to, and modifications are suggested to various schemes intended to reduce inequalities, but the belief is nurtured sedulously in the public mind that inequalities could be reduced substantially, or even virtually eliminated, by means of taxation within the structure of a mixed economy. The logical culmination of this line of thinking is the Taxation Enquiry Commission's recommendation that it was important to strive by stages for the implementation of a "ceiling" on personal incomes.²

¹"Some Financial Aspects of Development Programmes in Asian Countries," Economic Bulletin for Asia and the Far East, Vol. III, Nos. 1-2, November 1952, p. 3.

²TEC Report, Vol. I, p. 154.

The Taxation Enquiry Commission,¹ it is true, did not recommend the immediate implementation of its recommendation. Nor did it neglect the problem of adverse effects on incentives. But it generally adopted the twin concepts of collective savings and reduction of inequalities through heavy income taxation. It could not sufficiently divest itself of the ideas that are current in the country. This is true of many writers in the field. Though the need to raise the ratio of savings to income generally is recognized, too often the first question raised is: how can we raise more tax revenue for the government? To treat this as the paramount question is to slip back into the older approach of treating government finances on a non-functional basis.

2. The Need for Public and Private Investment

The twin ideas discussed above clearly are inadequate as the basis for tax policy in underdeveloped countries. The necessity for raising more revenue in India may be readily conceded. But the more important and more fundamental problem is to raise the rate of savings in the economy as a whole. This must be treated as the paramount question. Undue emphasis on insuring collective savings may result merely in the replacement of private investment by public investment, whereas the great need is to raise the aggregate of public and private investment.

¹Referred to hereafter as the TEC.

The fact that much of private investment is directed towards projects of low priority does not mean that it should be curtailed, but merely that it should be re-directed into more productive channels. A mixed economy cannot progress without constantly increasing private investment. In any case, public investment cannot hope to reach the very high level that would be necessary, if private investment is not to be encouraged, or actually is to be curtailed. This is so obvious as regards tax-financed public investment that it is surprising how many have come uncritically to accept the apparently satisfactory solution of compulsory collective savings. Net capital formation stands around 7 per cent of national income in India. Let us assume that this to be raised to 12 per cent in order for fairly rapid growth to take place. Investment then has to be raised by 5 per cent of national income. Now the proportion of tax revenue to national income ranges around 7 per cent of national income.¹ Of this the government is able to spend very little on fixed capital formation. In other words, savings in the government sector until now have been very low or almost nil. Hence, for our target of 12 per cent investment to be reached merely by expansion of public investment, taxation must be increased to 12 per cent of national income and all of this increase must be invested. Thus if we assume that current expendi-

¹This is true also of Thailand, Malaya, and the Philippines.

ture is not to increase at all, we find that tax revenues would have to be raised by 71 per cent from their present level. It is doubtful if this increase can be achieved in the near future. Further, it is unrealistic to assume that current expenditure would or should not increase during the course of development. Building up of human capital and the social services necessary for it are as important as the creation of plant and machinery. If, accordingly, allowance is to be made for concurrent increases in "non-capital" expenditure, the increase in taxation called for would be significantly higher. Such a program would require that the proportion of national income taken in taxation be increased very steeply "so that it eventually would include both the 15 per cent or so which modern welfare governments need for current purposes and another 20 per cent or so for gross capital formation."¹ This is the level of taxation that would be required, around 35 per cent of gross national product, if a country is to rely primarily on tax-financed public investment. When it is remembered that the present level of taxation is around 7 per cent of the national income in India, the unrealistic nature of this target would be recognized at once. Compulsory collective saving has a place in developmental finance, but it alone clearly cannot do the job.

It is not contended that tax revenues should not be increased; indeed every effort must be made to that effect.

¹Economic Bulletin for Asia and the Far East, Vol. III, Nos. 1-2, November 1952, p. 3.

It is contended, however, that a satisfactory level of capital formation cannot be achieved on that basis alone. A satisfactory solution must be sought along the three lines of private investment, public investment financed by taxation, and public investment financed by borrowing from the public. All three methods should be given importance, if rapid economic development is the foremost aim of economic policy.

Even where public investment is given priority, as in a socialistically inclined society, there is no reason why much of public investment should not be financed by borrowing from the public. Investment in some social overheads like education and other social services properly may be financed through taxation. But when the state goes beyond these activities and invests in remunerative projects like railways, electricity undertakings, and steel mills, borrowing from the public is a legitimate method of financing.

A word may be said about private investment. There is no need to canvass the case for increasing private investment in a mixed economy. If the needed scale of private investment in the right directions is not forthcoming, the right approach would be to encourage wise entrepreneurial effort. It is not as though, in India, all private investment is in the wrong directions and no business man is interested in productive investments in manufacturing industries. Data are now available which give an indication of the part which some entrepreneurs are willing to play in the country's economic development.

The TEC made an analysis of the balance sheets and profit-and-loss accounts of some public companies for the years 1946-51.¹ This analysis revealed that corporate savings provided a larger source than new subscriptions, on the whole, in financing industrial expansion during the post-war period. This is true of old as well as new companies, though in the former corporate savings played a more important part than in the latter.² It also appeared that a significant, part of fresh capital went into new companies.³

The Reserve Bank of India more recently has studied the growth of 750 joint-stock companies in India during 1950-55.⁴ Since the total paid-up capital of the companies included in the study constitutes two-thirds of the total paid-up capital of public limited companies in the sectors covered, the results of the study are of some significance in indicating the trends in the private sector. The study revealed that gross and net fixed assets recorded a rise of almost 50 per cent each during the 5-year period.⁵ Profits rose steadily from the year 1952.⁶ That the rise in profits was

¹TEC Report, Vol. I, Chapter 7. The analysis was based mainly on balance sheets and profit-and-loss accounts for common companies in 1946 (407) and in 1951 (448), and on a questionnaire in respect of 492 companies.

²Ibid., p. 115.

³Ibid.

⁴"Finances of Indian Joint Stock Companies, 1950-55," Reserve Bank of India Bulletin, September 1957, pp. 839-899. The 750 companies studied are those with a paid-up capital of Rs 500,000 or more. Banking, insurance, and investment companies have been excluded.

⁵Ibid., p. 839.

⁶Ibid., p. 840.

in large measure due to additional investment is indicated by the fact that whereas profits (both before and after tax) rose by about 50 per cent between 1950 and 1955, profits before tax as percentage of the total capital employed rose only from 9.0 to 10.2 per cent.¹ We also find that, from 1953, an increasing proportion of profits was retained in business.² This accrual of larger profits and larger internal savings in the corporate sector more or less coincided with a marked improvement in the rate of investment in private industry.

Private capital formation in industry in absolute figures also is not inconsiderable. Gross capital formation during 1946-51 in the manufacturing sector for all public limited companies was estimated at Rs 6.71 billion; of this, fixed asset formation (gross) amounted to Rs 3.17 billion, giving an annual average of Rs 630 million.³ In the period of the First Plan, private investment was stepped up considerably. The rate of investment in factory enterprises in industry is estimated to have risen from an average of Rs 260 million per annum in the first two years of the First Plan to Rs 440 million in the third year, Rs 500 million in the fourth year, and Rs 850 million in the final year.⁴ These latter figures are exclusive of the expenditure on modernization and replacement of machinery.

¹Ibid.

²Ibid.

³TEC Report, Vol. I, p. 114.

⁴Government of India, Planning Commission, Review of the First Five Year Plan, p. 4.

These data suggest that the oft-repeated statement that businessmen in underdeveloped countries like India are not interested in productive investments, must be accepted only with qualifications. More specifically, it would seem that, in recent years, entrepreneurs in India have shown a healthy interest in expanding manufacturing industries, and that an increasing proportion of rising profits tends to be retained and ploughed back into investment. Apart from these tendencies, entrepreneurs have also been willing to start new industries, if they could secure the capital needed.¹ In these circumstances, public policy must seek to encourage and strengthen private inducement to invest, while other measures are taken to step up public investment.

In the light of the foregoing discussion, it seems reasonable to state that the fundamental aim of tax policy should be to raise the ratio of savings to national income, and not just or even primarily to insure collective compulsory saving. If more savings could be generated in the economy, then the public and private sectors could each get a larger share of the savings. In the case of the public sector, part will come through taxation, and part through borrowing. Tax policy should not be ~~concerned~~ merely with

¹The amount of loans disbursed to various concerns by the Industrial Finance Corporation of India has continuously moved up from Rs 145.3 million in 1954-55 to 265.1 million in 1956-57. The Chairman of the Corporation stated in October 1957 that the loan applications which the Corporation had not been able to consider had already "swollen to an unprecedented volume." (Commerce, Vol. XCV, No. 2436, November 16, 1957, p. 897.)

avoiding curtailment of the incentives to saving and enterprise, it should go further and strengthen incentives to saving and investment. The rule of compulsory saving can be applied wherever voluntary saving out of large incomes is not practiced.

3. The Principle of Taxation According to Ability to Pay

When the primary objective of tax policy is the promotion of private and public investment, the tax structure must satisfy canons somewhat different from some of the traditional rules of taxation developed for western economies. As Mrs. Hicks says: "Naturally the outlines of a tax structure tailored for development will look substantially different in a conventional underdeveloped economy than in a highly sophisticated economy like ours."¹ Yet, by and large, traditional concepts and principles hold the field. This is partly a matter of "international demonstration effect." In this, as in other fields of economics, concepts developed in advanced economies frequently are transposed to underdeveloped economies. One such concept is that of taxation according to ability to pay. This concept has come in handy, in India as in the West, to support any kind of proposal for highly progressive taxation of income and wealth. To give one example, the then Finance Minister of India, in his budget speech of May 1957, justified his new tax on wealth on the basis of ability to pay. He said: "It

¹Ursula K. Hicks, "Direct Taxation and Economic Growth," Oxford Economic Papers, Vol. VIII, No. 3, October 1956, p. 303.

is recognized that income as defined by existing Income Tax laws and practice is not a sufficient measure of tax paying capacity and that the system of taxation on income has to be supplemented by taxation based on wealth."¹ But the question may be raised whether it is so obvious that the tax structure in India should be based strictly on "the ability to pay" of individuals as measured by their incomes and wealth.

In the theory of taxation, a tax has been defined as a compulsory payment to a public authority in return for which the tax payer receives no measurable direct benefit. Thus it is a contribution to defray the costs of common benefits flowing from governmental operations. This contribution, it is argued, should be in accordance with a person's ability to pay, or taxable capacity. It is further held that the principle of ability to pay leads to a progressive scale of taxation, on the basis of some one of the sacrifice theories and the law of diminishing marginal utility as applied to income.

The validity of this last inference often has been questioned and denied. In fact it has been shown that the principle of ability to pay does not lead unambiguously to any particular scale of taxation. Each person, in accordance with his own political predilections, can make a convenient assumption as regards the rate of diminution of marginal utility, and then come up with a proportional or progressive

¹Government of India, Ministry of Finance, Finance Minister's Speech, May 15, 1957, pp. 11-12.

scale of taxation. "Furthermore we cannot determine the meaning of 'equal sacrifice' unambiguously. It is open to several possible interpretations, each of which is as good or as bad as any other."¹ Thus the theoretical structure built on the basis of the principle of ability to pay to justify progressive taxation is almost wholly unsatisfactory. Nevertheless, a highly progressive system of taxation in respect of individual incomes is widely held to be the most desirable form of taxation. Despite the sophisticated theoretical arguments adduced in support of such taxation, one is inclined to agree with Kaldor that it is the desire to reduce economic inequalities which is the most important motive as well as justification for adopting a highly progressive tax system in terms of its burden on incomes.² The increasing need for governmental revenues to execute wars or to prepare for them also has forced governments to take money where they can find it. However, in the realm of theory, the principle of ability to pay still enjoys pride of place among the canons of taxation, hallowed as it has been by the support of economists from the time of Adam Smith and even earlier. Thus it is that teachers of public finance in underdeveloped countries also refer to the principle of ability to pay as the fundamental principle of

¹Gunnar Myrdal, The Political Element in the Development of Economic Theory, tr., Paul Streeten, Harvard University Press, Cambridge, Mass., 1954, p. 174. See "The Theory of Public Finance," chapter 7 of this book, for a thorough discussion of this question.

²Nicholas Kaldor, op. cit., pp. 26-27.

public finance and seek to build a tax structure on that basis.¹ It may be that in doing so these economists are impressed with the explicit theoretical justification given for progressive taxation of income, while they lose sight of the real motive behind it, which is the reduction of inequalities.

If the reduction of inequalities is the real justification for adopting highly progressive taxation of income in developed economies, it is not clear why the same system should be copied in underdeveloped countries, unless it can be shown that this is the best method of reducing inequalities in these latter countries also. In other words, the question of reducing inequalities must be taken up and considered separately, keeping in view the peculiar conditions obtaining in underdeveloped countries and the specific requirements of a developing economy. An attempt will be made later in this thesis to show that steeply progressive taxation of total incomes really is not the best method of tackling the problem of inequalities in underdeveloped countries.

However that may be, let us for a moment grant that the principle of ability to pay does lead to progressive taxation of income, as many people seem to insist. Even so, this principle can be applied rigorously only if we assume

¹A glaring example is Mr. R. N. Bhargava who goes to the extent of saying that "Modern researches have improved upon Manu and have given a theoretical proof of the validity of progressive taxation." (The Theory and Working of Union Finance in India, 1956, p. 21.)

that taxation is solely a contribution to defray the costs of certain common benefits. But the functional finance approach cannot treat taxation in this simple manner. This approach, in an underdeveloped country, will consider taxation more a powerful tool to raise the rate of net investment than a mere contribution to finance governmental services. It is true that there are many items of governmental services that have to be financed somehow, but the volume of governmental services that could be undertaken in the future itself will be dependent on the rate of investment and economic progress. It is the rate of investment then that must be assigned the first priority. It follows that the principle of ability to pay cannot be applied in a simple manner to the problems of taxation in underdeveloped countries and that it cannot be made the corner-stone of tax structure in these countries.

It is interesting to note that, although the principle of ability to pay could be shown to be applicable only by reference to the fact that at least the essential governmental services have to be financed by tax contributions, in practice, this very fact leads to a departure from this principle. In underdeveloped countries the finances needed cannot be raised mainly through direct taxes on income and wealth. Actually, the main reliance is on indirect taxation, and so the tax structure becomes regressive. Writers on the subject and finance ministers come to face a dilemma when they proceed to apply their principle to practice. More should be raised in taxation to finance public consumption

and investment expenditure; but if this is done mainly through progressive direct taxation, economic incentives would be affected seriously. So whenever taxation is raised to some extent, the burden of indirect taxation increases more, the tax structure remains regressive, and nothing is done to encourage private saving--at least nothing significant. The dilemma referred to above can be resolved only if we abandon the traditional interpretation of the so-called principle of ability to pay.

4. Taxation and Economic Surplus

Writers on underdeveloped areas point generally to the low level of savings in these areas. This level must be raised; but, according to many economists, such cannot be done to any significant extent because of the low level of per capita income which is said to be the cause of the low level of savings and investment. From this follows the concept of the vicious circle of poverty. It is doubtful, however, if the rate of savings in an economy, or at least the potential savings in an economy, can be related directly to the level of per capita income as such. The share of the national income going to the upper income groups and the share of property income in total income are probably more important determinants of the potential rate of savings.

Certain rough computations made by Mr. S. J. Patel indicate that the share of property incomes in India and the United States is not very different. Mr. Patel worked out the distribution of the national income of India for

1950-51.¹ From this he has drawn the following conclusions: (a) more than half of the national income is accounted for by the income of the self-employed; (b) wages and salaries represent nearly 23 per cent of the total, which is much smaller than the share going to wage and salary earners in the United States; (c) gross income associated with property ownership in India amounts to a little more than 23 per cent of the total.² The last conclusion is significant for our purposes. In broad terms, the income from property in the United Kingdom and the United States has varied between 20 and 25 per cent of the total over the last ten years or so. But whereas in the United States the groups which receive this share of the income save a considerable part of it, their counterparts in India fail to do so. As regards the distribution of income in India by groups of income receivers, Mr. Kuznet's calculations show that the top quintile gets about 55 per cent of the national income. The same situation exists in other countries of the region. A comparative study of income distribution in the United States, Ceylon, Japan, and the Philippines, made by ECAFE, showed that the degree of inequality was more or less the same in the countries covered.³ It was also seen that in Ceylon 10.6 per cent of income receivers received 37.0 per cent of the

¹S. J. Patel, "The Distribution of the National Income of India, 1950-51," The Indian Economic Review, Vol. III, No. 1, February 1956, p. 8.

²Ibid., p. 9.

³Economic Bulletin for Asia and Far East, Vol. III, Nos. 1-2, November 1952, p. 23.

income, and that in the Philippines 10 per cent received 33.3 per cent of the income.¹ In the light of these data, it is difficult to accept the argument that these countries cannot afford to save and invest a higher proportion of their income than a mere 5 per cent.

It is clear that in these countries the potential rate of savings is higher than the actual rate of savings. A plausible explanation for the marked divergence between the two is given by Mr. Patel:

Although per capita income in India is low, the possible rate of savings does not have to be significantly lower than in the developed countries, for the proportion of the saving-generating income, or gross property income, in both cases is approximately the same. The low rate of productive investment in India may, therefore, be explained, not by a reference to the low average income, but the preponderance of "feudal" income (in property income), which in the main is sterile at present for furthering economic development.²

In all pre-industrial societies, agriculture contributes more more than half of the national output, and a significant part of this accrues to what we may call "feudal" proprietors and intermediaries. Economic development can be accelerated if the larger part of this "surplus" can be made available for productive investment. Such surplus may exist in other sectors of the economy too. One of the central tasks of fiscal policy is to mobilize such surplus for purposes of economic development.

¹Ibid., p. 22.

²S. J. Patel, op. cit., p. 11. Italics in the original.

Accordingly, the starting point for any realistic theory of public finance for underdeveloped countries must be the concept of the economic surplus generated in the economy. Though the concept of economic surplus is somewhat tricky, it is a valid and useful one for our purposes. Civilization is made possible for any society or nation when its economic system begins to generate a surplus over essential consumption.¹ Following Professor Baran, we may distinguish between actual economic surplus and potential economic surplus.² Actual economic surplus is the difference between actual current output and actual current consumption. It is thus identical with actual accumulation of various assets. Potential economic surplus is "the difference between the output that could be produced in a given natural and technological environment with the help of employable productive resources, and what might be regarded as essential consumption."³ Part of this surplus may not actually materialize because of waste of resources in idleness and mis-employment. The rest of the surplus is utilized for various purposes. The character of a civilization and its future progress depend on the purposes for which and the manner in which this

¹It is of course impossible to define precisely the term "essential consumption." It is not fixed for all time, nor is it the same for all countries and groups; nevertheless, for a given society, at a given time, it is possible to have a rough idea of the essential consumption required in its quantitative and qualitative aspects. Other concepts are used in economics which cannot be defined rigorously: for instance, depreciation.

²Paul A. Baran, The Political Economy of Growth, Monthly Review Press, New York, 1957, pp. 22-23.

³Ibid., p. 23.

surplus is utilized. The surplus can be used for what the classical writers called "unproductive consumption," or for "unproductive investment" (palaces and pyramids), or for productive investment. Economic progress requires that, in the initial stages at any rate, a high proportion of this surplus be channelled into productive investment. In an agrarian country like India, a great part of the surplus originates in the agricultural sector and is appropriated by landowners, moneylenders, and merchants who usually do not possess the habit of productive investment. According to a number of observers, India can invest 15 per cent of her income without any reduction of mass consumption.¹ What is required for this purpose is a comprehensive mobilization of the economic surplus currently generated in the economy. The communists attempt to do this by socialization of industry and collectivization of agriculture. In a democratic society, the alternatives are voluntary saving and, in its absence, taxation. The task of tax policy for economic development, accordingly, is to mobilize this surplus, direct it into productive channels, and continually to enlarge its size.

5. Canons of Taxation for India

Granted the above, what should be the fundamental principle underlying the tax structure? It should be the principle of the mobilization of the economic surplus. Taxation must mop up a great part of the surplus which at

¹Mentioned in ibid., p. 225.

present is not being used for productive investment. The problem is to discover the surplus and channel it into investment without, in the process, destroying or gravely restricting its occurrence.

The second canon is that each person should be made to contribute to taxation in accordance with his unused capacity or ability to contribute to economic development. This ability can be measured in terms of that part of the economic surplus (or the claim to it) accruing to him which he is not already, on his own, utilizing for productive investment. A person's income can be said to contain a surplus if it is above the level needed to maintain the minimum consumption necessary for efficiency and for incentives. This minimum will obviously differ in different countries and for different classes of the population.

Taxation also must mobilize the increases in the surplus that arise as a result of initial developmental efforts. This is the same thing as increasing the incremental saving ratio. Hence the third canon of taxation is that it must be so fashioned as to prevent consumption from increasing proportionately with income in the earlier stages of development. As will be shown later, commodity taxation can be used effectively for this purpose.

The fourth important canon of taxation for India is the canon of income-elasticity of taxation. As incomes rise the share of taxation in total incomes must rise. At present all the governmental units in India together take in taxation only around 7 per cent of the national income. Even

if it is not possible immediately to raise the share of the government, it is imperative to do so as national income begins to register significant increases. As will be seen readily, this requires built-in flexibility in the tax system. To impart the needed flexibility to the tax system, it is necessary to tax goods that have a high income-elasticity of demand and also adopt a progressive scale of income taxation. Since the marginal rate will be higher than the average rate, the share of the government will increase more than proportionately as income increases.

Last, but not least, there is the canon of equity. Since taxation is to be used as a tool to promote economic development, the rule of equity demands that the burdens involved in rapid economic development be distributed equitably among the different sections of the population. This is exactly what is done when a great part of the surplus in the economy is channelled into investment. If the poorer classes are prevented from increasing their consumption to the full extent of the rise in their incomes, the richer classes are prevented from using their surplus for excess consumption. Sacrifices in consumption are shared alike by all members of the society. A corollary from this general rule, one that often is forgotten, is the rule of horizontal equity. That is to say, people in similar circumstances and behaving in the same manner (in terms of their utilization of the surplus) must be treated equally for tax purposes. This is an unambiguous rule of equity and yet it is one that the Indian tax

system does not satisfy.¹

B. Taxation of Income and Wealth

1. The Case for a Partial Exemption of Savings from Income Taxation

It has been suggested that taxation for economic development must fall on the economic surplus and mobilize it for investment, and that it must be so fashioned as continually to enlarge the surplus. From this it follows that taxation must be levied on a progressive scale on that part of the income (above a certain level) that is not used for approved investments, and that the manner of taxation must be such as to encourage individuals to save. In other words, there is a case for exempting from income taxation savings which are invested in directions which are considered socially necessary.

Such total exemption is justifiable only if we consider taxation solely as a tool for promoting economic growth; in fact, however, taxation is also a contribution to finance governmental services. Further, a part of the surplus is needed for public investment in social overheads. Therefore, a compromise solution would be to grant a partial but sufficient exemption. If one realizes the over-riding necessity to raise the rate of savings in the economy, one would agree that such an exemption is absolutely necessary.

¹See below, Part IV.

There are many considerations which, in the peculiar institutional setting of India and other South Asian countries, support the above-mentioned scheme for encouraging private saving alongside of public investment. First, it would not be desirable to channel most of the surplus into public investment. Public and private investment have to go hand in hand because much of public investment is intended to raise the marginal productivity of private investment.¹ Second, even in India with the "socialist pattern of society" as its ideal, the greater part of the economy, however measured, is left to private enterprise. This is seen from the Industrial Policy Resolution of the Government of India of April 1956. According to this resolution, only industries of basic and strategic importance, those in the nature of public utility services, and those which require investment on a scale which only the state can provide, are to be in the public sector.² The development of all other industries is left to private enterprise. In this institutional setting, to inhibit private enterprise would be to inhibit economic development. Third, the state mostly undertakes relatively unremunerative enterprises. Many of the government enterprises may bring in direct monetary returns, but they are not such as to yield large profits. Therefore, the growth of surplus in the economy must depend on the growth of remunerative sectors outside the public economy. Finally, and above all, it is not sufficient merely to avoid weakening

¹See above, Part II, B, 2.

²Second Five Year Plan, pp. 45 and 50.

incentives to saving and enterprise; if rapid economic development is desired, it is necessary to go further and strengthen incentives. This is no less a compelling duty of the state than the provision of overhead capital.

These are weighty considerations which reinforce the case made earlier for a partial exemption of savings from income taxation. It might be objected, however, that when we depart from the principle of ability to pay and progressive taxation of total incomes, we are abandoning equity. This really is not so. As we have already seen, the principle of ability to pay does not lead definitively to any particular scale of taxation. It cannot therefore be maintained that taxation that is slightly regressive with reference to income necessarily is inequitable. The more important point is that economic development requires sacrifices in consumption and that these sacrifices must be distributed equitably among all sections of the population. A tax system that heavily penalizes consumption and rewards investment induces every one concerned to forego consumption. In a developing economy, equity must be understood, after all, in a dynamic setting. It is only through economic progress that the standard of living of the masses can be raised appreciably. A tax system that distributes the incidence of taxation in the conventionally "equitable" manner may do less than justice to them. Dr. Boulding has shown that if re-distributive measures should lower the rate of economic progress, the absolute share going to the group favored by the redistribution will, after a point of time, be less than what it would have

been with a higher rate of growth.¹ This means that it is not in the interests of any group to accept a re-distribution in its favor which lowers the rate of growth. The usual welfare economics of public finance is tied up with static assumptions. "'Justice' has been thought of too much in terms of the division of a fixed pie rather than in terms of encouraging the baking of more pies."² Justice in taxation in an underdeveloped country cannot mean anything more than an equitable distribution of the burden involved in capital formation and the promotion of the highest possible rate of growth.

As has been pointed out already, an equitable distribution of the "burden" of economic development involves the application of the rule of horizontal equity. In India, in our attempts to find a rule for treating people in dissimilar circumstances, we have not paid adequate attention to this unexceptionable rule of equity. Salaried personnel are taxed while shop-keepers escape; incomes from profits and those from salaries are not treated similarly because of the generous provisions concerning deductible expenses in the former case; agricultural incomes are treated leniently; and lastly, incomes in the form of capital gains completely escape taxation.

Under our scheme, capital gains would qualify for taxation on the basis that they are beneficial receipts which

¹Kenneth E. Boulding, "Fruits of Progress and the Dynamics of Distribution," American Economic Review, Vol. XLIII, No. 2, May 1953, pp. 481-482.

²Ibid., p. 483.

form part of the surplus in the hands of individuals, and which can be used by them for consumption or investment. Taxation of capital gains not only will mete out more even justice between different individuals but also will close one of the well-known loop-holes for tax avoidance. Taxation of capital gains, however, must be accompanied by a partial exemption in favor of savings.

It is not intended to argue against progressive taxation; it is submitted merely that the base should not be the total income. This may well mean that the tax system will be slightly regressive with reference to incomes. But the system will be very highly progressive with respect to that part of the income which is not being invested productively. This scheme serves a double purpose: if a large income is not saved, a significant portion of it will be appropriated by the state; on the other hand, if the income is to escape heavy taxation, it must go into investment. Either way the surplus is mobilized for economic development. In this manner, the scheme helps us get out of a basic dilemma in tax policy, which is that more should be raised in taxation but that this cannot be done for fear of destroying incentives. Under the scheme now being discussed, even if the government loses somewhat in tax revenue, it would have succeeded in stimulating saving of which it can take a share.

What is needed is a practical and workable scheme by which partial exemptions can be granted for savings that are invested in certain directions. Such exemptions must benefit all kinds of income tax payers, not just the recip-

ients of dividends and owners of corporations. Since encouragement to investment must be given at the individual as well as at the business level, the scheme would involve modifications in the taxation of both personal and business income. It may be pointed out, incidentally, that all those who do not pay income tax automatically enjoy tax benefits on their savings because they pay only taxes on their consumption.

The scheme of exemptions is not anything revolutionary. Exemptions have been granted, in India and elsewhere, for charitable contributions, for insurance and provident fund payments, and for certain capital investments by corporations. It may be more important to encourage investment than charity, especially in an underdeveloped country. And clear social benefits arise when a person uses his income not for personal consumption but for investments that augment the productive capacity of the economy. In this connection, one is reminded of the words in which Keynes described the economic system of Europe in the latter-half of the nineteenth century:

Thus this remarkable system depended for its growth on a double bluff or deception. On the one hand the labouring classes accepted from ignorance or powerlessness, or were compelled, persuaded, or cajoled by custom, convention, authority, and the well-established order of Society into accepting, a situation in which they could call their own very little of the cake, that they and Nature and the capitalists were co-operating to produce. And on the other hand the capitalist classes were allowed to call the best part of the cake theirs and were theoretically free to consume it, on the tacit underlying condition that they consumed very little of it

in practice.¹

Under the tax system proposed here, the richer classes would be "theoretically free" to call the tax-exempt income their own, but they would not be able to consume it. Instead of relying on a "tacit underlying condition," we would "cajole" and "persuade" the richer classes to abstain from consumption through a well-ordered scheme of taxation.

It is true that if we grant partial exemption to savings, the income tax will be less effective in reducing inequalities of wealth. However, since the rates of income tax can be stepped up under the scheme, inequalities in the standards of consumption will be reduced. This is the best that can be done for the masses in the short run. For reducing inequalities of wealth-holding and for preventing the perpetuation of inequalities, reliance should be placed on a much heavier inheritance taxation than exists at present. If a country wishes to rely on private enterprise at all, it has to encourage the accumulation of wealth up to a point. It is necessary for people to command substantial amounts of wealth in order to start and run large firms. The sooner it is realized that a degree of inequality, in excess of what the idealist reformer will allow for, is inevitable, the better it is for economic progress. If a country does not want inequalities of wealth and at the same time desires rapid economic progress, it probably should adopt a predominantly socialist system. Even in such a system a high

¹J. M. Keynes, The Economic Consequences of the Peace, Harcourt, Brace and Howe, New York, 1920, pp. 19-20.

degree of inequality of incomes will continue to exist.

2. A Scheme for Exempting Approved Investments from Taxation of Income

The problem is to devise a practicable and effective scheme which would encourage individuals to save more out of their incomes and invest the savings in "desirable" directions. In particular, the need is to encourage investment in equities and government securities. The scheme must be capable of dividing the "economic surplus" between the private and public sectors. This is in keeping with our earlier reasoning.

a. Personal Income. A highly progressive income tax would continue to be levied. All capital gains would be treated as income for tax purposes. Such a system without other features would, if enforced, eat up private savings, discourage people from saving, and might seriously affect all economic incentives.

Therefore we have to build-in a scheme for the encouragement of savings and for the enlargement of the surplus. Accordingly, partial exemption from income tax should be granted to certain investments. The exemption would apply if out of the income of the year assessed, or out of capital gains, or through the decumulation of other forms of wealth, actual investments are made in the form of purchases of newly-issued government securities or new capital issues by corporations. Since capital gains would be taxed, it is assumed that records of all transactions in stocks and shares and government bonds would be kept. If an individual should sell some stock that he now owns and buy new issues of an equiva-

lent amount, he would not qualify for the exemption. If he bought old or existing securities, then too, according to this scheme, he would not qualify for this exemption (however, see alternative scheme suggested below).

There would be three rates of exemptions:

- (a) one rate for investment in government bonds that are newly issued; say, 15 per cent;
- (b) another rate for investment in equities of corporations, that is, newly issued shares; say, 20 per cent;
- (c) the highest rate for capital gains if invested in either of the above; say, 30 per cent. There seems to be a case for treating capital gains more leniently.

Usually a case is made out either for a complete exemption of capital gains from income tax or for a special treatment of them. Many economists seem to prefer the latter course on the ground that capital gains constitute irregular income. In the United States long-term capital gains are treated leniently. Under the scheme proposed capital gains qualify for lenient treatment if they are again invested in particular directions. Thus the possibility of discouraging people from investing for reaping capital gains is avoided and at the same time all receipts that are spendable are brought under tax charge.

If a person buys out of current income \$100 worth of a new government bond issue, he need pay tax only on \$85. If he buys a new equity issue, then he need pay tax only on

\$80. If out of a capital gain of \$100, he buys either of the above, he need pay tax only on \$70. If the person sells a bond he bought at \$100 and buys a new one at the same price, he does not qualify for any exemption.

How will this affect the market for old securities and for securities in general? It may be objected that the market for old securities will be affected seriously and that people may not even buy new issues for fear that they may not be able to re-sell them. Will it be the case that no one will be willing to buy old securities? First, when securities worth a certain amount are sold and others worth an equivalent amount are bought, there are no tax benefits. Therefore, for those who want to get rid of certain securities, it is a matter of indifference whether they buy new ones or old ones. They may prefer to buy the old ones if they expect a capital appreciation. Second, even out of current income people may decide to buy certain old securities if they feel that these are going to go up in value. Third, there is a certain amount of risk involved in buying the securities of newly floated corporations. Some would prefer to invest in the securities of well-established concerns. Fourth, the existing securities are held by someone or other. So what we really have to consider is whether the exemption scheme as proposed here would actually induce people to buy "new" issues, or retard such investment, or be just neutral. There is a possibility that people may fear that once they buy securities, they may not be able to re-sell them without loss. Even if there is some such

fear, it may still be clearly profitable to buy the "new" securities. For example, if a person in the 50 percent marginal-rate bracket buys new stock worth \$100 and if a 15 per cent exemption is granted, then he pays \$42.50 as tax instead of \$50. He will be discouraged from the purchase of the new stock concerned only if he fears that as soon as the stock becomes "old" it will sell at a discount of \$7.50. The capital value of stock is affected by various factors like confidence in the corporation's future, its dividend policy, capital appreciation through reinvestment, etc. Thus there is no reason to expect the "old" stock to sell always at a discount or at substantial discount.¹

However, an alternative scheme may be suggested which will not give rise to this problem. Instead of the exemption being limited to the purchase of "new" issues, it could be extended to the purchase of any government bond or corporation stock. If this is done, we would have to take into account decumulation of stock holdings. That is to say, if a person enjoys an exemption when he buys stock, he must forfeit the benefit thus derived when he sells it without replacing it by stock of equivalent worth. This provision is necessary to prevent many people from benefiting by purchasing the same stock in succession. In this scheme then, the total cost of securities already possessed by a person has to be

¹However, this scheme might open up a loop-hole for tax avoidance. If the old securities should sell at a discount, some tax-payers might "engineer" capital losses to be offset against capital gains.

taken into account. Let us say that a person buys stock worth \$500 after the exemption scheme goes into operation. He enjoys the appropriate exemptions. If at a future date he sells part of this stock which cost him \$200, he would pay an extra tax on \$30 (15 per cent of \$200 which originally was tax exempt), unless he buys stock worth \$200 to replace what he has sold.

The Taxation Enquiry Commission suggested another scheme.¹ It advocated the levy of a surcharge on income tax. This surcharge was to be loaned back to the tax payer at nominal rates of interest provided the money was used to buy approved securities. The securities bought thus were to be pledged with the Internal Revenue authorities to prevent their sale. This scheme is less comprehensive than the one suggested above. Further, it seems undesirable to require the deposit of securities. Presumably the securities will not be returned unless the loan is paid back. But a person should not be prevented from selling his stock if he has some need for money. All that can be required reasonably is that if he should so sell the securities, he should forfeit the benefit he earlier derived by the investment. Thus the decumulation of stock holdings on the part of any person is discouraged. Moreover, the present scheme is designed to benefit all tax payers. The taxation Enquiry Commission's scheme will benefit mostly the upper income groups because

¹TEC Report, Vol. II, pp. 143-144.

only they may be in a position to pay back the loans. In fact the TEC confined its scheme to upper income groups.¹

The scheme of exemptions outlined above may appear unorthodox and quite novel. And at first sight it might look unacceptable to many economists and financiers. Yet some such scheme is urgently called for in view of the overwhelming need to raise the rate of savings. The TEC itself carefully considered the problem of providing for incentives in the tax system. It recommended a number of measures calculated to promote investment in the private sector. Most of its recommendations in this regard, however, are related to business taxation. In the matter of personal income taxation, in order to promote investment in special directions, it put forward the scheme of surcharge on income tax and loans for investment referred to above. It might be added that even before the TEC submitted its report, a number of concessions designed to promote investment had been incorporated in the Indian tax system. Therefore, the idea of exemptions really is not quite new. The TEC said:

It must be recognized that restriction of relief to these two forms of savings, viz., insurance and provident funds, gives a certain degree of stimulus to investment in government securities and other comparatively less risky forms of investment and correspondingly restricts the scope for risk-bearing equity investments. Theoretically, there is a case for including other forms of savings within the scope of relief; if all forms of savings could be included we shall have found a way by which income-tax is converted into what in effect would become a pure spending tax.

¹Ibid.

The problem would be to find forms of savings or to work out administrative procedures which prevent liability to abuse of any wider extension of the relief.¹

Mrs. Ursula Hicks, discussing taxation and economic growth, suggests a few modifications to the existing system of income taxation in the United Kingdom and then concludes: "Nevertheless, we should clearly also look at more adventurous alternatives, such as Mr. Kaldor's expenditure tax."²

Thus the need for some device to promote investment is felt keenly by eminent authorities in the field of public finance. The scheme that has been put forward in this thesis is designed to fulfill this keenly-felt need. The TEC could not think in terms of such a comprehensive scheme because it did not envisage the taxation of capital gains. The main argument it advanced against the taxation of capital gains was that it would discourage investment in equities. We have already indicated a way by which this danger could be avoided to a considerable extent. According to Mrs. Hicks, a capital gains tax would definitely discourage risk-bearing, because whenever a switch of holdings took place, the capital appreciation would be taxed, whether or not the funds were re-invested.³ But according to the proposed scheme, the capital gains concerned would be taxed lightly if they were re-invested. Once we introduce the taxation of capital gains, the whole scheme becomes administratively workable.

¹TEC Report, Vol. II, p. 143.

²Ursula K. Hicks, "Direct Taxation and Economic Growth," op. cit., p. 309.

³Ibid., p. 314.

b. Business Income. We now turn to taxation of business income. The TEC made certain recommendations regarding taxation of business incomes. First, it recommended the granting of a development rebate of 25 per cent in a few selected industries of national importance.¹ This rebate would reduce taxable business income by 25 per cent of any investment in plant and machinery made in the assessment year. This recommendation is in line with our reasoning because it relates the exemption directly to an act of investment. Second, the TEC gave its general approval to the then existing practice of (a) giving a rebate on undistributed profits, (b) granting additional depreciation allowances on new investments, and (c) granting exemption from taxation to profits of new concerns up to a specified period of time. Of these, the rebate on undistributed profits has been abolished since then.

If we take the TEC's proposals as a whole, we find that they cannot be related back to any central principle of taxation. Hence they fail to be uniform in their impact on different classes of tax payers. They seem to be weighted heavily, and unnecessarily so, in favor of businesses and business classes. If exemptions are to be granted, why should they not be made available to all classes of the population? Further, the exemption of the profits of new concerns is not based on any well-defined principle of taxation, except the general desirability of promoting investment. At

¹TEC Report, Vol II, p. 99.

any given time, the profits of a number of businesses are removed completely from the sphere of governmental control and cannot be manipulated to counteract inflationary pressures. We are interested in stimulating investment out of income and re-investment out of the profits of past investment. Exempting the profits of new companies from taxation would have the effect of allowing the recipients of such profits to do what they pleased with them. It is better to grant the exemption as and when the investment is made than to do it after the investment is made, i.e., in the succeeding years.

The structure of business taxation that is envisaged is as follows. Incomes of partnerships and individual proprietorships would be treated like all other personal incomes in the matter of rates and exemptions. In the case of limited companies, there would be a non-refundable corporation tax levied on their net profits before distribution. Apart from paying this tax, the corporation would act merely as a collecting agency for the income tax on dividends.

The corporation tax has been justified on the grounds (a) that the corporation is a separate entity and therefore has a separate ability to pay; (b) that it enjoys the benefits of incorporation and could justifiably be subjected to additional taxation; and (c) that without a corporation tax the undistributed profits of companies will escape taxation. In a growing economy corporations are the source from which a significant and growing volume of surplus is generated in the economy. Corporate taxation must serve the twofold purpose of encouraging the re-investment of this surplus and

securing a part of it for public investment. The best scheme probably would be to levy a flat-rate tax on corporate profits and grant the development rebate in the case of selected industries. The latter, of course, would apply to all forms of businesses though restricted to selected industries.

It is possible to make use of accelerated depreciation allowances and development rebates as alternatives. When the profits of a new corporation are first brought under charge, accelerated depreciation could be granted. This would apply to investment made prior to the date of first taxation. In respect of investments of a specified nature made after that date the development rebate could be granted. Additional depreciation allowances amount merely to interest-free loans; the development rebate on the other hand is a more costly device because it reduces tax liability. It must, therefore, be used sparingly and vigilant watch must be kept over possible abuse.

Since only a flat and, at least in the initial stages, a moderate rate of tax would be levied on corporations, there does not seem to be any strong case for granting a rebate on undistributed profits. Such profits bear the corporation tax, but when used for investment they reduce tax liability through the development rebate in industries of national importance. Undistributed profits call for special provisions only in the case of closely held companies. The tax laws of most of the advanced countries contain safeguards against tax avoidance through excessive retention of profits in such companies. We agree with Dr. Lakdawala

that such safeguards should be retained.¹

The scheme of exemptions for savings is made applicable to investment in all securities because that makes the scheme relatively simple and administratively workable, and also because it is desirable to afford a general stimulus to investment. Undesirable or low-priority investment could be prevented by direct control of capital issues. On the other hand, discriminatory commodity taxation and the restriction of the development rebate to specified industries would encourage investment in particular directions.

c. Tax Rates and Exemption for Saving. One great advantage of the proposed scheme is that the rates of taxation can be raised without deleterious effects on savings. Generally speaking, the rates of income tax are much lower in the underdeveloped countries than in the developed countries. This is especially true of the lower and middle income groups among the taxpayers, the rates in the upper ranges of the income scale often being quite high. Martin and Lewis made a comparative study of the tax systems of 16 different countries (developed and underdeveloped) and came to the same conclusion.² They point out that the general practice in the underdeveloped countries is to have a high exemption limit for personal incomes so that a man earning

¹D. T. Lakdawala, Taxation and the Plan, Popular Book Depot, Bombay, 1956, p. 200.

²Alison M. Martin and W. A. Lewis, "Patterns of Public Revenue and Expenditure," The Manchester School of Economic and Social Studies, Vol. XXIV, No. 3, September 1956, p. 223. India is one of the countries covered by this study.

an income comparable to ₹200 a year usually escapes altogether from income taxation.¹ These conclusions are true in general of the Indian tax system.² In the upper income ranges, the tax rates are very high and are comparable to the rates in existence in the most advanced countries. But in the middle and upper-middle income ranges, the rates are low in comparison with the rates in the advanced countries. To illustrate: at Rs 1 million the effective rate is 81.5 per cent and at Rs 100,000 it is 58.8 per cent; however, at Rs 15,000 the effective rate is only 8.9 per cent and at Rs 10,000 it is only 5.9 per cent.³ The exemption level is Rs 3000, which exceeds 10 times the per capita income. There may be ample justification on administrative grounds for such a high exemption level, and those below this level are being reached through indirect taxation. But it seems clear that there is some scope for stepping up the rates in the middle and upper-middle income ranges. It is suggested that this can be done simultaneously with the inauguration of a scheme for the exemption of savings.

d. Possible Objections to the Scheme Proposed. Two possible objections to the scheme of exemptions can be anticipated. The first one is likely to be that the state would lose considerably in tax revenue. This objection does not have much force. As argued above, tax rates could be raised, once the scheme of exemptions is instituted. Even if this is

¹Ibid.

²See Table XII.

³Ibid. These rates are applicable to an unmarried person when the income is wholly "unearned."

not done, there is no reason to suppose that the long-term yield of taxation will be any less under this scheme; indeed, in so far as the scheme promotes investment, the yield may be greater because of higher taxable profits. Further, if we enforce strictly the rule of horizontal equity we shall be able to bring under charge considerable income that now escapes taxation. Capital gains, agricultural incomes, incomes of moneylenders and shop-keepers--all these are not being taxed adequately now. They should and could be taxed effectively. We have suggested also that tax holidays to industries should be terminated. The net effect of these measures may be that the yield of income tax will not suffer any noticeable fall even in the short-run.

Though the scheme of exemptions has the direct short-run effect of diminishing the amount of tax revenue that can be raised from a given volume of assessed income at given tax rates, it might at the same time increase the volume of savings obtainable through government bonds. Borrowing from the public is quite a suitable method of raising resources for some types of investment (for example, investment in power projects and re-lending to private businesses). Several of the underdeveloped countries, including India, have such small debt burdens that they could afford to finance much development by borrowing.¹ After all, in India much the greater part of public capital formation (in fixed assets) has been financed so far by borrowing from the public and

¹Alison M. Martin and W. A. Lewis, op. cit., p. 212.

credit creation. In the Government of India budget for 1957-58, net capital formation by government in that year was estimated to be Rs 3.95 billion, while net savings by government was estimated to be only Rs 150 million.¹ Further, the combined budget estimates of the States for the same year showed a deficit on revenue account of Rs 866 million, which more than counterbalanced the surplus at the central level.² This means that, on the balance, public capital was financed by means other than current revenues. The proposed financing of the Second Five-Year Plan also shows that public investment in the five-year period, 1956-61, will be financed through borrowing and credit creation.³ Out of a total of Rs 48 billion of public expenditure under the plan, Rs 10 billion are of current nature (on education, social services, etc.). Such expenditure does not create productive assets and has to be reckoned as non-investment expenditure. The investment component of the plan then amounts to Rs 38 billion. As against this composition of plan expenditure, the surplus available from current revenues in the five-year period is estimated to amount to Rs 9.5 billion only. Thus no surplus is available for investment expenditure proper. It is not intended to argue on the basis of these figures that public investment should not be financed by government surpluses. Our argument is that since the achievement of a sizeable

¹Reserve Bank of India Bulletin, April 1957, p. 340.

²A. G. Chandavarkar, "Finances of State Governments," Reserve Bank of India Bulletin, August 1957, p. 736.

³Second Five Year Plan, pp. 77-78.

surplus seems almost impossible in the near future, a scheme that promotes savings in the economy might insure at least that public investment would be financed largely by genuine borrowing, and not by credit creation.

The second objection to the scheme of exemptions is likely to be that the tax system, rather than reducing economic inequalities, actually will increase them. Since larger incomes when saved are less heavily taxed under the scheme, inequalities of wealth will increase in course of time. There is considerable truth in this contention. And unless we introduce countervailing measures to check the growth of inequalities, the scheme might prove unacceptable to the great majority of people in India as well as in other Asian countries. The problem is to discover the best methods of insuring that economic inequalities will not exist or grow beyond certain socially defined limits. It is to this problem that we now turn.

3. Taxation and Economic Inequalities

Inequalities of incomes have significance in the short run mainly in so far as they permit great inequalities in the standards of consumption. If it is insured that a large proportion of the higher incomes is saved, then inequalities in the standards of consumption are narrowed down to that extent. A scheme of progressive income taxation which favors savings together with a suitable pattern of commodity taxation can go a long way toward the objective of reducing disparities in the standards of consumption of different classes. Much depends also on the pattern of investment that is promoted

through planning or otherwise. The standards of consumption of the poorer classes will improve, not deteriorate, if fairly high priority is given to investment in wage-goods industries, in education, and in measures designed to reduce the rate of growth of population. It is obvious, of course, that the production of wage-goods would and should increase continually as development plans get under way. This increase is absolutely necessary so long as there is disguised unemployment. In so far as the rate of increase in the production of wage-goods is greater ~~than~~ the rate of increase in population, the level of living of the masses will gradually rise. Whether the poor become poorer depends very much on the pattern of investment.

The TEC discussed the proposal for placing a ceiling on incomes.¹ For any such proposal to be meaningful, "income" must be defined in a comprehensive way to include all "beneficial receipts." If this were done, however, and an effective ceiling were placed on "incomes," the consequences certainly would be disastrous. As Kaldor points out, even a country like the United States cannot afford to do such a thing.² Highly progressive income taxation really is not the most suitable method of dealing with the problem of inequalities. Progressive taxation with nominally high rates have not succeeded

¹TEC Report, Vol. I, p. 154. As mentioned earlier, the TEC was disposed favorably towards this proposal.

²Nicholas Kaldor, Indian Tax Reform--Report of a Survey, Department of Economic Affairs, Government of India, New Delhi, 1956, p. 11. This report is referred to hereafter as Kaldor Report.

in appreciably reducing inequalities of income and wealth because there are many loopholes in the tax systems of most of the advanced countries. Indeed that seems to be the reason why highly progressive scales of taxation have not produced serious adverse effects. It is suggested that the problem of dealing with inequalities should be examined afresh, especially in underdeveloped countries.

There are three aspects to the problem of inequalities: inequalities of income, inequalities of wealth, and the creation of a growing class of rentiers. Inequalities of income, in the absence of government intervention, make possible wide disparities in the standards of current consumption and, in course of time, accentuate the unequal distribution of wealth. The latter may be considered to produce two undesirable consequences. The concentration of wealth in the hands of a few may carry with it the concentration of economic power; and when large wealth-holdings are transmitted through inheritances and bequests, a class of rentiers is created, who can earn large incomes and consume them without any social justification to support their claims on the social product. Thus, a country with pronounced egalitarian ideals may object to three undesirable consequences of inequalities: disparities in the standards of consumption, concentration of economic power, and the creation of a class of rentiers. The problem then really is to prevent or mitigate these consequences without inhibiting growth.

It is necessary here to emphasize two considerations that should not be lost sight of in dealing with this problem. The first is that there are definite limitations to what can be done in this regard in an economy based to a large extent on private enterprise. These limitations arise from the very requirements of such an economy. If it is desired to promote growth in the setting of a mixed economy, it becomes necessary not only to encourage work, risk-taking, and private capital formation, but, more important than that, to allow individuals to hold sufficiently large amounts of wealth to enable them to start, run, and control large-scale enterprises based on efficient methods of production. It could be argued that the adverse effects of heavy taxation are vastly exaggerated; but it cannot be argued that we should not allow individuals to hold large amounts of socially useful forms of wealth. Under given technological conditions, it must be possible for an individual to hold a certain minimum of wealth in order to own or control enterprises based on efficient methods of production. It is, of course, not possible to define this minimum rigidly; nor would it remain fixed for all time. But if we lay down the general order of magnitude involved, it could then perhaps be said that accumulation beyond the minimum has no social justification. Such accumulation could be discouraged or prevented. But the conclusion is inescapable that a certain degree of inequalities of wealth will have to be "tolerated" in a mixed economy.

The second consideration is that the three consequences of inequalities referred to above, though inter-related, may

be best dealt with through separate measures. It is the attempt to deal with them through a single measure that raises the dilemma of equity versus growth. Highly progressive taxation of total income tries to cut down at once the standards of consumption of the higher income groups and the accumulation of wealth. In doing so it does not discriminate between the surplus that is used for productive investment and that which is used for extravagant consumption. The main social significance of inequalities of incomes in the short-run is that they lead to very unequal standards of consumption. It is therefore suggested that the income tax be used mainly to prevent lavish consumption and "unproductive" investment on the part of the higher income groups. This is what is done when a steeply progressive income tax is levied and at least a partial exemption is granted for approved investments.

Inequalities of wealth and their perpetuation through inheritances could be dealt with through a system of gift and inheritance taxes. It might be argued that heavy taxation of inheritances and gifts would induce the rich to dis-save. But high rates would be made applicable only to estates that are above the socially desired minimum mentioned above. Further, if the tax is based on the size of the inheritances rather than on the size of the estates, the incentive to dis-save may not be great. In any case, under the scheme of exemptions proposed earlier, decumulation of stock and bond holdings will be penalized. It is far better to encourage accumulation and then try to prevent the growth of a rentier class than prevent all accumulation. The danger

of the very rich dis-saving is undoubtedly present, but in so far as this concerns a relatively small number of people it is only a small price to pay for achieving the goal of a more nearly egalitarian society.

The dis-saving by the rich, however, reduces to some extent the effectiveness of income taxation as a means of curtailing their high consumption standards. It may, therefore, be considered necessary to minimize the inducement to dis-save. With this object in view an alternative scheme may be suggested. Since the cause of dis-saving would be the high rates of inheritance taxation, the rates could be made moderate enough not to afford a powerful incentive to dis-save. But an annual tax on wealth with a high exemption level could be levied to supplement the inheritance tax. The only purpose of the annual tax on wealth would be to discourage accumulation beyond a certain level, and virtually prevent it after a second, higher level is reached. As was argued earlier, an individual must be allowed to hold a certain minimum of wealth in order to be able to own and/or control large-scale enterprises, etc. This must mark the exemption level for the annual tax on wealth. Since this tax would be levied in addition to the income tax, even if the rates are only low and mildly progressive, after some point above the exemption level, further accumulation would be virtually prevented. Thus such a tax would in effect place a "ceiling" on wealth.

Considerable danger is involved, of course, in any hasty introduction of a ceiling on wealth. And it is clear that the exemption level must be fixed only after the most

careful consideration. Nevertheless, in a country like India, where most of the basic industries that experience decreasing costs over a wide range of output are (to be) in the public sector, there is no case for allowing indefinite accumulation of wealth in individual hands; and a reasonably-conceived ceiling on wealth may not result in highly deleterious effects. It might be added, however, that, of the two schemes put forward, the first one with heavier inheritance taxation and without an annual tax on wealth is to be preferred. The annual tax on wealth involves difficult problems of valuation, and it is by no means easy to find the proper exemption level. On the other hand, it is easy to exaggerate the tendency of inheritance taxation to induce the rich to dis-save.

The net effects of our proposals on taxation of income and wealth would be as follows: (a) inequalities in the standards of consumption will be narrowed down; (b) accumulation of socially useful forms of wealth will be encouraged; (c) accumulation in general will be discouraged after a certain level; (d) inequalities in the ownership of wealth will continue to exist; (e) but concentration of wealth in a few hands will be prevented and there will be a virtual upper limit to the holding of wealth.

It must be pointed out that the whole scheme is set forth in the light of the basic goal of India's national policy which, here taken as a datum, has been declared by Parliament to be the establishment of a socialist pattern of society. It is envisaged that such a society will be in the nature of a mixed economy with important places accorded to

both public and private sectors. All "basic" industries of national importance will be eventually in the public sector, private enterprise will be encouraged in all other fields, and economic inequalities will be kept within socially desirable limits. The desire of the Indian people in general seems to be to build a more nearly egalitarian society than what exists at present. It is in the light of this desire and the nationally accepted goal that this set of tax proposals has been formulated.

C. Indirect Taxation

1. The Role of Indirect Taxation

It is common knowledge that indirect taxes play a very important role in the finances of underdeveloped countries. The structure of indirect taxation in these countries has to be fashioned with the same objectives as direct taxation. It must be such as to raise the rate of capital formation in the economy while providing revenue for public consumption and investment. Here again we must ask not simply how to raise more revenue for the government, but rather how to raise the rate of investment and at the same time get more revenue for the government. It is necessary to consider also the effects on the incremental savings ratio.

One justification for the taxation of articles that are widely consumed is that it is necessary to raise enough revenue to finance at least the essential governmental services. In underdeveloped countries it becomes necessary to raise the greater part of tax revenue through commodity

taxation. Looked at this way, commodity taxation is a contribution to meet the costs of common benefits and must be levied in as "equitable" a way as possible. High rates on luxuries and low rates on articles of common consumption are widely accepted rules. Such differentiation in rates introduces a broad element of progression.

When we look upon commodity taxation as a weapon for promoting economic growth, its justification lies in the fact that it has a tendency to restrain consumption. However, it should be used more for checking potential increase of consumption than for curtailing the actual consumption of the masses. It is easy to justify taxation that is intended to curtail the consumption of luxuries and other commodities not essential for health and efficiency. But the taxation of goods consumed by the general population in a poor underdeveloped country may seem to go contrary to our principle of laying the axe only on the element of surplus. The question may therefore be raised whether taxation of mass consumption has any role at all to play in developmental financing. Since there is scarcely an element of surplus in the incomes of the masses of the people, it would be clearly undesirable as well as unjustifiable to force them to contribute to economic development out of their meager incomes. To argue that such taxation is necessary for the maintenance of essential governmental services is one thing; but to say that we must augment tax revenue from this source to raise the current rate of investment is an entirely different thing. As will be shown later, such a policy may not even

be successful.

From the point of view of functional finance put forward in this thesis, the role of mass commodity taxation is not to raise the rate of investment at any given moment; it is to prevent consumption from rising as much as income rises as a result of past investment. It is for this reason that mass commodity taxation becomes essential in underdeveloped countries even from the point of view of economic development.

Raising the incremental savings ratio is one of the most difficult problems in underdeveloped countries. It must be remembered that it is not enough to persuade or cajole the richer classes alone to save and invest. In so far as a substantial part of the increase in incomes accrues to the poorer sections of the population, they are in a position to consume more than before. Their marginal propensity to consume being very near unity, their consumption will tend to rise almost as much as their incomes. If this is allowed to materialize, the increases in productivity will be almost fully absorbed by increased consumption. Increased commodity taxation could be used at this juncture to restrain increases in consumption and thus release some factors for purposes of investment.

The same holds good in respect of agriculture. When agricultural productivity increases, the peasants have a tendency to increase their consumption of farm products, especially of food. Again, when part of the under-employed labor force is drawn into industrial employment from the

rural sector, those who remain on the farms may increase their consumption. On the other hand a continuing expansion in industrial employment requires an increase in the marketable surplus of agricultural products. Therefore, taxation might have to be used to transfer a part of the growing surplus from the rural to the urban sector.

It is not suggested, of course, that there should be no increase in the output of consumption goods; only that increases in productivity should not be fully absorbed in the consumption-goods sector. Indeed a rapid increase in the supply of some types of consumer goods is highly desirable in the context of disguised unemployment--even apart from humanitarian or political reasons. This will become clear when we examine the meaning in real terms of "increasing the incremental saving ratio."

For purpose of this analysis, let us classify consumer goods under three heads: (a) necessities: required by all but the only goods available to those who are on the margin of subsistence; (b) non-necessaries: these can be and are being consumed by a fairly large number of people who are above the subsistence level in varying degrees; and (c) luxuries: these are consumed mainly by the well-to-do./

Suppose that the population remains constant and that there is no disguised unemployment. Net investment will increase the real income of the population. This means that people will have higher money incomes at about the same level of prices, or about the same money incomes at a lower level of prices. When an individual's real income rises, he

attempts to move in the scale of consumption from necessities to luxuries. If this movement is restricted, we can have increased production of investment goods, instead of an increased production of non-necessaries and luxuries. The level of living remains constant or rises only a little, but the ratio of investment to income rises.

Suppose now that there is disguised unemployment in the economy and that it is desired to reduce it in course of time. The transfer of the under-employed to industrial employment creates the well-known "wage-goods gap." That is to say, though these people were consuming a certain amount of goods in their previous state of under-employment, the total demand for wage-goods in the economy rises when they are given industrial employment. This happens for two reasons: (a) they have to be paid a rate of real wages greater than their average consumption in partial idleness; and (b) those on the farms who are rid of their dependents tend to increase their consumption. In these circumstances, the volume of disguised unemployment cannot be reduced unless there is some increase in the output of wage-goods. In other words, the output of necessities and some non-necessaries typically consumed by workers must increase, if we are to reduce the volume of disguised unemployment.

Suppose now that population is increasing, as it actually is in underdeveloped countries. When it is remembered that large sections of the population in these countries live on the margin of subsistence, it is clear that there must be a rapid increase in the output of necessities

and even some non-necessaries. So the role of indirect taxation is not to reduce the output of necessities but to raise the incremental saving ratio. For this purpose, it has to be used in two different ways. First, it has to be used to restrain a rapid expansion in the output, or even curtail the output, of many non-necessaries and luxuries. Second, it has to be used to transfer part of the increased output of wage-goods to the investment and/or industrial sector. This ultimately, is the rationale of the taxation of mass consumption from the point of view of economic development.

It must be remembered that the curtailment or restraint of consumption applies only to luxuries and non-necessaries. In the case of necessities, what is required is only that a part of the increase in their output must be made available to the investment sector. To achieve this latter purpose it is clearly not necessary to tax necessities themselves. Take, for instance, the question of increasing the marketable surplus of food. Taxation of the basic articles consumed by the masses will in no way help in inducing or forcing the farmers to part with a greater volume of farm output. More of farm output can be got in exchange for a given volume of non-farm output by turning the terms of exchange against the farmers, that is, by raising through taxation the prices of non-necessaries which farmers would wish to consume in increasing quantities with a rise in their incomes. Nor is it necessary, by tax measures, to restrain the consumption of necessities by other sections of the population, in favor of those who are given employment in the investment

sector; for the wages paid to the latter will automatically enable them to claim a part of the available supply of wage-goods in the economy.

Writers on the subject of fiscal policy in underdeveloped countries generally deplore the need to require the masses to contribute to economic development through higher taxation; but they often conclude that such taxation is inevitable. Now what exactly does one mean when one talks of forcing the masses to contribute to economic development through higher taxation? At any given time, the supply of wage-goods is fixed and is available for consumption. Higher taxation cannot immediately reduce actual consumption. Substantial reduction in consumption will come about only when taxation begins to curtail the output of consumer goods. But this will not be allowed to happen in the case of all consumer goods. The composition of future output will depend upon the pattern of present investment. Most investment plans currently under operation allow for a considerable increase in the output of wage-goods. Indeed as developmental plans get under way, the output of many different types of consumer goods will increase. How fast consumption output increases, and what kinds of goods will be produced in increasing quantities will depend, as pointed out above, on the pattern of investment. For instance, the more investment is keyed to deepening the capital structure of the country, the less rapid will be the rise in consumption output. Since some capital deepening is involved in all development, the pattern of investment will not, in all probability, allow

for a rapid increase in the output of non-necessaries and luxuries. This policy will require the masses only to put up with a rather slow rise in the level of living, and not reduce their consumption of necessities.

From the above analysis it is clear that the main role of mass commodity taxation is to check a rapid rise in mass consumption. This conclusion has some important implications for policy. First, there is no case for taxing necessities. Second, non-necessaries and mass luxuries can be taxed at fairly low rates to begin with. The rates on articles of mass consumption should be raised only when there is a clear indication that per capita output of such articles is rising. It may be pointed out also that, in so far as the pattern of investment is determined by the planning authority, taxation merely serves to bring the pattern of future consumption in line with the pattern of investment. To tax necessities, and at the same time increase their output through government investment and subsidy, is a clearly contradictory policy.

The TEC put forward a recommendation that goes contrary to our conclusion above. Discussing the most suitable structure of commodity taxation for India, it makes the statement: "Additional taxation of a wide range of luxury or semi-luxury products, at fairly substantial rates, accompanied by broad-based taxation of articles of mass consumption at comparatively low rates, is, therefore, indicated."¹

¹TEC Report, Vol. I, p. 149.

This is a statement to which no exception can be taken. But it goes on to say: "For any substantial receipts from commodity taxation and appreciable restraint on consumption in the economy as a whole, it will be necessary to extend excise and sales taxation to the consumption of lower-income groups and of goods commonly classed as necessities, including several goods which are included in the Essential Goods Act under Article 286 of the Constitution. ...An extension of the taxation of necessities appears unavoidable, if significant results by way of diversion of resources for financing public investment, are to be secured."¹ Some of the goods included in the Essential Goods Act are not essentials in the strict sense of being necessities of life for the lowest-income groups. But as regards the necessities of living, the Commission's recommendation is not acceptable at all. It is based on a purely "revenue approach" to the question of developmental financing and misconstrues the nature of diversions to be achieved.

If it is true that large sections of the population are living on the margin of subsistence, it is not clear how any policy designed to curtail the output of necessities can be justified. On the contrary, it has been shown above that both the fact of population increase and the need to reduce disguised unemployment call for a rapid increase in the output of at least the basic necessities. The First and the Second Five-Year Plans have provided for substantial increases

¹Ibid.

in the output of these necessities. Therefore, the statement of the Commission that "an extension of the taxation of necessities appears unavoidable, if significant results by way of diversion of resources for financing public investment ^{be} are to/secured," goes directly contrary to the intentions of the planners themselves as well as to conclusions from economic analysis. (Emphasis added.)

2. Analysis of the Effects of Indirect Taxation

It has been shown above that from the point of view of economic development the three main objectives of indirect taxation are: (a) raising resources for public investment; (b) raising the rate of investment in the economy by curtailing the consumption of luxuries; and (c) raising the incremental saving ratio. In order to achieve these objectives the state is interested in causing diversions of resources and of purchasing power in certain ways and directions. There are three types of diversion that would become necessary: (a) diversion of resources from the private to the public sector; (b) diversion of resources from consumption goods industries to investment goods industries within the private sector; and (c) diversion of demand from imports to domestically produced goods.

The second type of diversion is achieved through differential taxation. Taxation of luxuries and exemption of capital goods, for instance, would cause some diversion of this nature. We have already discussed in an earlier section how the same objective can be promoted through progressive income taxation with a partial exemption for savings.

The third type of diversion is caused by import duties. Import duties may be levied, as part of a program of development, in order to give initial support to domestic industries against the competition of more developed foreign industries. It may be levied to restrict the consumption of imported luxuries. Such taxation is effective only in so far as the domestic production of luxuries is simultaneously curtailed. Finally, import duties may be levied in times of inflation and of balance of payments crises, in order to restrict imports and siphon off part of the excess purchasing power in the hands of the public. It must be remembered, however, that retaliatory import duties by other countries would render ineffective this particular method of tackling the balance of payments crises.

As regards the first type of diversion, the state should seek to transfer resources to itself with as little inflationary or other undesirable effects as possible. Two separate operations are involved in this transfer. The first is the acquisition of purchasing power by the state; the second is the purchase of the factors of production by the state, which automatically returns the purchasing power to private hands. It is generally argued that if, under conditions of full employment, the purchasing power is acquired through credit creation, there is likely to be some inflationary effects, but that if it is done through taxation, there would be no such inflationary effect. That is why taxation is generally preferred to credit creation as a means of transferring resources to the government under con-

ditions of full employment of factors of production. Indirect taxation of commodities, however, leads to some rise in price in most cases. The extent of the price rise and the commodities affected would depend on the goods taxed and bought, respectively, by the government. Under certain circumstances, increased indirect taxation on a wide scale might lead to considerable rise in prices, which might lead to a rise in wages. This result would tend to nullify the effects of indirect taxation in so far as the reduction of the purchasing power of the people is concerned.

The ultimate economic effects of taxes depend not only on the nature of the taxes themselves but also on whether the tax revenue is spent and if so, in what directions. In what follows it is assumed that the revenue collected is all spent without significant lag. It is also assumed that all factors other than labor and natural resources are more or less fully utilized. The analysis is carried on in a setting of pure competition except when specified otherwise.

The effects of indirect taxation can be analyzed conveniently under the following heads: (a) revenue effect; (b) diversion effect; (c) price effect; and (d) distribution effect.

a. Revenue Effect. When a tax is levied on a commodity which continues to be produced and sold, there is a flow of revenue to the government. We can of course think of a tax that does not bring any revenue at all to the government; for example, a high protective duty. It is obvious, however, that there must be in the tax system at least some

important taxes which would bring substantial revenue to the government. These are taxes on goods that have a low price-elasticity of demand. The price-elasticity of demand for the same commodity on the part of different groups is often very different. When the income of a person increases, it is likely that his demand for certain goods will become less elastic. This is another justification for taxes on goods with a high income-elasticity of demand since, as income increases, such taxes tend to increase revenue more than proportionately.

b. Diversion Effect. Taxes on particular commodities have a tendency to cause a diversion of resources from the industries concerned. The extent of the diversion, it is generally argued, would depend on the relative elasticities of supply and demand. The more inelastic the demand or supply is, the less is likely to be the diversion caused by the change of tax. But the expenditure effects may modify the tax effects. The proceeds of a tax may be spent in such a way as to lead an additional demand for the same commodities whose sales have been reduced by the increase of tax. For example, if taxes are levied on wage-goods, or existing tax-rates are raised, and the additional proceeds are spent primarily in employing labor that is presently under-employed, then there may be no net reduction in the demand for wage-goods. In other words, the total quantity bought may remain the same, or possibly increase somewhat, even though the price has risen. The diversion is one of employment.

At this point it must be made clear as to what exactly we mean by elasticity of supply. When a tax is imposed on a product, the marginal cost of production is increased. Under competitive conditions the price cannot be raised directly. Therefore the producers tend to reduce output and hence reduce their demand for factors. This causes a fall in factor earnings. Supply can be considered elastic if the owners of resources would reduce their offering of resources when their rate of remuneration is thus reduced. They may do this (a) if they decide that it is not worthwhile offering their services or resources in the former quantity at the lower rate of reward, or (b) if they can find a higher rate of return in other fields for some part of their resources. In the majority of cases we can safely assume that only the second cause will be of importance.

We must now see under what conditions factor owners will be able to find a higher rate of return in other industries than in the taxed industry. They could obtain a higher return elsewhere (a) if the resources are not specific and can be used in a large number of other industries, and (b) if increased government expenditure creates a demand for the same factors or products that they can produce. If neither of these conditions is fulfilled, the factors will have to stay in the same field and accept a cut in their earnings. It is then that we may say that the supply of the product taxed is inelastic. In the following discussion the term "inelasticity of supply" is used in this sense. In the short run, supply can be inelastic. In the long run, however,

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enough resources to replace the exhaustion or removal of existing ones will not enter the taxed industry, and the total supply of resources in the industry will shrink; for owners of non-specialized resources can earn higher rewards for increments of investment in industries other than the taxed industries. Thus in the long run the supply of factors will become fairly elastic to the taxed industry.

Let us consider the diversionary effects of taxes on particular commodities with different degrees of elasticity of supply and demand (absolute elasticity and inelasticity being ruled out).

(i) relatively elastic supply and relatively elastic demand. Since the supply is elastic, there is restriction of output and some resources leave the taxed field. The objective of diversion of resources is achieved to the greatest extent in this case. Since the demand is elastic, the consumers spend a smaller amount on this commodity at the higher price. This enables them to spend more on other commodities and/or save (more). Increased expenditure on other commodities diverts some resources to other private sectors.

(ii) relatively elastic supply and relatively inelastic demand. Under these conditions, the diversion from the taxed industry is not as great as in the first case. Consumers would spend more on this commodity at the higher price than before and would therefore have to cut down saving or spending elsewhere. Hence the greater part of the diversion takes place in other sectors of the economy.

(iii) relatively inelastic supply and relatively elastic demand: Under these circumstances, reversing the comparative elasticities, the diversion from the taxed industry is likely to be about the same as in the previous case. There will be some rise in price and consumers will spend less on this commodity and more on others. In this case, the tax comes more out of the cut in earnings of the factors than through a rise in price. This fact causes a corresponding diversion of resources. Since we have assumed that supply is not absolutely inelastic, the degree of elasticity of demand would make some difference. With an elastic demand consumers would have more to spend on other commodities; with an inelastic demand less to spend on other commodities.

(iv) relatively inelastic supply and relatively inelastic demand: In this case the reduction in output is likely to be the least of all four cases. Though the demand is inelastic, the price rise will not be considerable since the supply is inelastic and resource owners will have to accept a cut in earnings. Consumers would be spending a little less on other commodities. Here again the diversion of resources is caused in other sectors of the economy.

From the above analysis it follows that, in the short run, output in a particular industry is reduced least by a given increase of tax when both supply and demand are inelastic. Hence this is the case of the greatest revenue to the government but of minimum of diversion from the taxed industry. When both supply and demand are elastic the diversion caused is the greatest, but the revenue yield is the smallest. In

the long run supply will be elastic because specificity of resources is essentially a short-run phenomenon. In the long run, therefore, cases (i) and (ii) are of greater relevance. In these cases we find that when demand is elastic, the greater part of the diversion is caused from the taxed industry; and that when demand is inelastic, the greater part of the diversion is caused from other industries. Further, in the latter case the revenue produced by the commodity tax is greater than in the former.

c. Price Effect. The government, it must be remembered, is ultimately interested in transferring certain resources to the public sector or to the private investment sector. Typically, these resources consist of different types of intermediate goods and labor--both skilled and unskilled. We have to examine how the process of transfer affects the price level under different assumptions.

When a commodity is subjected to increased tax not matched on all commodities, there is a tendency for its output to be reduced (except as change of expenditure may counter this effect). To what extent the reduction in output would raise its price or reduce the incomes of factors engaged in producing the commodity would depend on the relative elasticities of supply and demand for the commodity. Let us assume that the demand is of unit elasticity and concentrate our attention on the supply side. If the factors of production are mobile, and can be used to produce certain other goods less adversely affected by tax changes, some units of the factors will move into the industries producing these

goods and their supply will increase. Their prices will fall, as will also the prices of the factors concerned. The price of the taxed good, on the other hand, will rise. The larger the number of industries in which the factors can be used, the smaller will be the fall in their incomes, and the greater the rise in the price of the taxed commodity. On the other hand, the larger the number of commodities taxed, the greater is likely to be the fall in factor incomes, and the smaller the rise in the prices of the taxed goods.

These are the results if we assume that the tax revenue is not spent. However, our general assumption is that the tax revenue is all spent. If public expenditure creates some demand for factors used in the taxed industry, or for goods that can be produced with these factors, then the fall in factor incomes and in the prices of the alternative products that they can produce will be arrested somewhat. Therefore the rise in the price of the taxed commodity will be correspondingly greater. Only if the factors concerned are completely specific and government expenditure creates no demand for them, will the adjustment be solely in the form of fall in factor incomes. This is the case of perfect inelasticity of supply which we have ruled out for practical purposes. In all cases of less than perfect inelasticity of supply, there is some rise in the price of the taxed commodity. On this basis, the assumption that demand is of unit elasticity can be relaxed.

Suppose that the elasticity of demand is greater than unity. With increase of price, consumers will spend

less on the taxed commodity than before. Consequently, they will have more to spend on other commodities, the demand for which will thereby increase. This additional demand plus the additional governmental demand may be satisfied by the release of factors from the taxed industry. This is the case of minimal price rise and disturbance in the economy.

Suppose now that the demand is of less than unit elasticity. The price rise is greater in this case. The consumers spend more on the taxed commodity than before, and the demand for certain other goods falls. This may lead to a fall in their prices. But much depends on the action of the government. If the government uses the revenue to buy resources used in the taxed industry, the last-mentioned result follows. If the government buys mainly resources used in entirely different industries, then the price rise will take place in these industries. If there is oligopoly in the taxed industry, then there may be a price rise in the taxed industry also, causing some unemployment of the factors of production which has further repercussions in the economy. Aside from monopolistic effects, the point to note is that the effect on different prices depends not merely on the tax change, but also on change in the way in which government revenue is spent, and that there can be a combination of price rises and falls. For instance, a tax on tobacco may have the effect of reducing the demand for movies and popular magazines; and the proceeds of the tax may be used to purchase steel, cement, and labor for construction. Since these resources do not play a very significant part in the

secondary industries affected, there is likely to be a rise in the price of steel and cement which may then affect the prices of other goods. Instead of tobacco, a number of necessities like salt, sugar, kerosene, cotton cloth, etc., may be taxed. It is then no consolation to the ordinary consumer to argue that after all the prices of movie admissions and magazines have fallen.

The discussion above brings out another point of importance, namely, that taxes on particular commodities can be shown to cause disturbances in different sectors of the economy. If the price rise and the disturbance are to be kept to a minimum, there is a presumption in favor of imposing additional taxation, when necessary, on industries competing for scarce factors needed in the public sector. When it is desired to increase public expenditure, financing it through increased commodity taxation, the criterion for selecting a new tax should not be primarily the degree of inelasticity of demand, but rather the degree of competition with the public sector for factors of production. Commodities with inelastic demand are favorite objects of taxation because taxes on these commodities bring in relatively greater monetary revenue to the government. It is true that, ceteris paribus, a tax levied at a given rate on a good with inelastic demand will reduce private incomes more than one on a good with a relatively elastic demand. Hence, if the aim is anti-inflationary action, it may be preferable to tax goods with an inelastic demand. But if the primary aim is the transfer of resources to the public sector for investment, it is prefer-

able to tax industries competing for the same resources. If the demand facing the industries is relatively elastic, the government should be able to acquire the factors at lower prices than would have obtained had there been no tax-induced shift of resources. Therefore, the degree of elasticity of demand need not be the deciding factor in the selection of commodities for additional taxation.

We now turn to the price effects of a general tax. The exact nature of the incidence and effects of a general sales tax has been a matter of some controversy and uncertainty among economists in recent years. The earlier attempts to generalize the conclusions about particular excises were not quite satisfactory because these conclusions were based on a type of partial equilibrium analysis. The general sales tax affects all industries and goods simultaneously and its effects must be analyzed in a general equilibrium setting.¹ In 1939, Professor Harry Gunnison Brown analyzed at some length the effects of a general sales tax and advanced the conclusion that its burden rests upon the factor owners in proportion to their incomes rather than on the consumers, as usually believed.² Professor Earl Rolph more recently has restated the Brown case and accepted his conclusions.³

¹A general sales tax, by raising the cost of capital goods, will affect the pattern of investment. We do not consider this effect of a general tax here.

²Harry G. Brown, "The Incidence of a General Output or a General Sales Tax," Journal of Political Economy, Vol. XLIII, April 1939, p. 254-62.

³Earl R. Rolph, "A Proposed Revision of Excise-Tax Theory," Journal of Political Economy, Vol. LX, No. 2, April 1952, pp. 102-117.

Professor Rolph assumes that there is perfect competition in the markets for all products, factors, assets, and claims, and that all prices are completely flexible. On the basis of these assumptions, he argues as follows: Under a completely general tax, there will be no untaxed fields to which factors can migrate in an attempt to escape a cut in their incomes. When the tax is levied, the firms are not in a position to raise the prices directly. They have, therefore, an incentive to reduce output. This means a reduction in the demand for hired factors as well as owned factors, which tends to reduce their incomes. Since there are no untaxed fields, the migration of factors is ruled out. The end result is that, if the tax is a uniform impost, there would be a proportionate reduction in the incomes of all factors. As regards the product mix, the uniform tax would be neutral. Rolph concludes: "The previous discussion has attempted to show that a uniform system of excise taxes of a completely general type does not raise prices to consumers, does not change the composition of output, and does reduce money incomes of resource owners proportionately."¹

Rolph does not take into account in his analysis the effects of the expenditure of the additional tax revenue. Since we have assumed that the tax revenue is spent, we must consider the effects of the tax-expenditure program as a whole. The final result of the program will depend on the

¹Earl Rolph, op. cit., p. 116.

assumptions we make about the effect on the level of aggregate money demand. We shall, therefore, discuss the price effects of a general sales tax under different assumptions about the level of money demand.

The exact effect on aggregate demand depends on (a) the extent to which private consumption and investment are curtailed as a result of the tax, (b) the expansionary effect of the use of the tax revenue, and (c) current monetary policies.¹ Assuming that there exists neither an inflationary nor a deflationary situation, we may inquire when, or under what circumstances, aggregate money demand will remain constant and when it will change.

The initial effect of a general tax, or of an increase thereof, under pure competition, is to reduce all factor incomes. Let us assume that the total private demand for goods is reduced to the same extent as the reduction in factor incomes. Now if the tax revenue is sterilized, there will be a tendency for the prices of goods to fall.² Thus a deflationary situation is created. In this case, the aggregate money demand has fallen.

On the other hand, if by chance the government should directly, and without delay, buy the same goods in the same amounts as factor owners would cease to buy because of the fall in their incomes, the price level would remain unchanged.

¹Cf. John F. Due, "Toward a General Theory of Sales Tax Incidence," Quarterly Journal of Economics, Vol. LXVII, No. 2, p. 258.

²Rolph fails to follow through the effects of the fall in factor incomes.

In this case, the aggregate money demand would remain as it was and there would be no change in the product mix or output. The money flow going into the firms would remain constant, but a part of it would be appropriated by the government. Consequently, factor incomes could not go up to their pre-tax level. Only in this very special case, dependent on all the assumptions made above, could the aggregate money demand and the price level remain constant.

Most probably the government will not purchase with the increased tax revenue the consumer goods for which private demand is reduced by the tax change. For developmental purposes, it would wish to increase mostly its purchase of factors of production. To the extent that tax revenue is spent this way, the government adds directly to the demand for factors in the economy. Factor prices to private firms will not fall (or if they fall initially, will rise now), and factor incomes remain in (or reach) their pre-tax levels. The main point to note in this connection is that the government's demand for factors as such tends to prevent a fall, which the tax increase otherwise would cause, in their prices in the economy as a whole. The result will be that the prices of products will rise. In this case the aggregate money demand has risen because the factor owners are in a position to spend as much as before the tax and, in addition to this, the government is spending the tax revenue.

Once the prices of products begin to rise, the elasticity of demand for different products becomes a matter of importance. The prices of goods with inelastic demand will

rise more than the prices of goods with elastic demand. As prices rise, consumers will spend more money than before on the former and less on the latter. It is reasonable to expect that the prices of necessities, on which the whole or most of wages are spent in an underdeveloped economy, will rise by more than the rise in the general price level.

The increase in the price level and in aggregate money demand necessarily will require an increase in money supply (MV). If we assume an elastic money supply, an increase in M can easily come about, when necessary. And the government's action in taking the tax from consumers' expenditure and spending it a second time, before it is paid out to factors, may tend to increase the velocity of circulation. Unless, therefore, restrictive monetary policies are being followed, an increase in money supply necessary to make possible a rise in prices will occur in the economy.

Some of the assumptions made earlier can be relaxed now. One assumption was that private demand would fall by the full extent of the tax amount. This would not be so if part of the tax is met by a reduction in savings without a corresponding fall in investment. In this case the tax will have a greater expansionary effect. Another assumption was that all factor prices were flexible. In fact, of course, many of them are sticky. To the extent that prices of some factors are sticky and cannot be pushed down, the prices of their products would tend to rise even apart from the expenditure of the tax revenue, or before it takes place. The same result follows if we remove the assumption of pure com-

petition. As Professor Due has pointed out,¹ under conditions of oligopoly, the firms can and will directly raise prices as soon as the tax is levied. This will result in some unemployment of the factors of production. But the factors that are thus thrown out of private industries may be absorbed in the public sector when the tax revenue is spent. Thus the final result is the same under imperfect competition as under perfect competition except that part of the tax may be absorbed in excess profits.

From the above discussion it will be clear that the case of constant aggregate money demand is a very special one. The more usual and realistic one is that of increased aggregate money demand with aggregate real factor demand remaining constant or also being higher. Therefore, the traditional conclusion that the imposition of a general sales tax results in rise in prices seems to be substantially correct. By contrast, an income tax-financed increase in public expenditure, under similar circumstances, is not likely to lead to a similar rise in the general price level. There will of course be some expansionary effect in so far as private factor demand does not fall as much as government demand increases. But in the case of the income tax, a part of the factor incomes is appropriated directly, and not by driving a wedge between the prices paid by the consumers and the incomes received by the producers. It is therefore reason-

¹John F. Due, op. cit., p. 257.

able not to expect a rise in the general price level as in the case of a general sales tax.¹

The above conclusion regarding the effect of a general sales tax is only a first approximation. It might be profitable to inquire into some further repercussions on the price level. In the earlier argument, the expenditure of tax revenue was held to restore the original level of factor demand and factor prices. The aggregate real demand for factors would be the same as before the tax, with private demand being less and government demand being greater. But would the additional government demand be for the same factors as are released by the reduction in private demand? If not, the rise in prices would tend to be concentrated, at least in the short run, in some sectors of the economy. Suppose, for example, that it is decided to step up public investment through additional sales taxation and that the additional revenue is used to finance a developmental project in which the proportion of labor to other factors employed is very high. Then, unless in the industries, for whose products private demand will decline, the same high proportion of labor to other factors is being used, there will be a net increase in the demand for wage-goods in the economy, because additional labor employed by the government will exceed that displaced from private industries.² In this case the price

¹For a similar conclusion, see Richard Goode, "Anti-Inflationary Implications of Alternative Forms of Taxation," Papers and Proceedings of the American Economic Association, May, 1952, p. 157.

²It is assumed that some labor will be drawn from the pool of disguised unemployment.

of wage-goods will rise to a greater extent than the general price level. In underdeveloped, over-populated countries, where developmental projects are often employment-oriented, this is a point of major relevance.

We may consider the reactions of different groups of consumers to the increase in the general price level. In a poor country the great mass of goods consumed is in the nature of goods necessary for subsistence and work efficiency. For our present purposes, the consumers in an underdeveloped country can be divided into three groups: (a) those who consume more than the minimum necessary for subsistence and efficiency and also have a margin of saving; (b) those who consume more than the minimum above but are not saving; and (c) those whose incomes are just sufficient to enable them to consume more or less the minimum. For the present we ignore those in disguised unemployment who may be consuming less than what is required to perform regular and sustained work. These three groups are listed here in the inverse order of their relative sizes. That is to say, in underdeveloped economies, group "c" is likely to be the largest. This is obviously not the case in a highly developed economy like that of the United States, where only about 10 per cent of families have an income of \$1000 and under.

When there is an increase in the price of consumer goods, group "a" can maintain its previous standard of consumption, if it wanted to, by cutting down saving. In practice, it might curtail partly its consumption of luxuries and non-necessaries. Group "b" is forced to curtail its

consumption, but still may be in a position to consume the minimum necessary for subsistence. Group "c;" however cannot maintain even the minimum of consumption necessary for subsistence and efficiency. Therefore, in the face of a rise in the prices of consumption goods, groups "a" and "b" have relatively less incentive to insist on salary and wage increases. It is possible to persuade them to accept a cut in real wages because, previously, they were above the subsistence level. But those members of group "c" who are engaged in wage-labor or in any kind of industrial employment must have an increase in money wages, if they are to maintain just the minimum consumption necessary for subsistence and work efficiency. Money wage levels are then likely to rise, leading to a further increase in prices which might well-nigh restore private demand to its original level before taxation.

That increased taxation of mass consumption would lead to a rise in the cost of living and that this might lead to demands for wage increases, is readily granted by economists.¹ But it is sometimes held that this possibility is strong only in advanced economies where labor is organized into strong unions. In an underdeveloped economy, where only a small proportion of labor is organized and has bargaining strength, the cut in real wages, it is argued, could be im-

¹See, for instance, Agricultural Taxation and Economic Development, ed., Haskill P. Wald, Harvard Law School, Cambridge, Massachusetts, 1954, p. 94.

posed more easily on large sections of the laboring classes. In the light of the above analysis, this kind of reasoning seems fallacious. Those who are living on the margin of subsistence have a different kind of bargaining strength! It is common knowledge that a large part of the labor force in a country like India lives on the margin of subsistence. It includes the landless workers on the farms, semi-skilled and manual workers of all kinds, and self-employed persons like the handicraftsmen. Most of the nonagricultural workers are employed in urban and semi-urban areas. However, many of them live in the villages and go to work in the towns. Under these circumstances, the supply of labor to the towns, at a subsistence wage, is likely to be extremely elastic. If a less than subsistence wage is paid, the laborer withdraws himself and returns to the village. Very often there is a family farm to which he can return.¹ In India, during and after World War II, this type of labor succeeded in obtaining a gradually increasing money wage, though of course wages lagged behind prices. Yet such labor was not organized into unions. While these workers are not in a position to raise their wages appreciably above subsistence, nature herself protects them by making impossible continued wage below subsistence. In conclusion, therefore, it seems inescapable that any considerable attempt to increase revenue

¹For a detailed description of the conditions of the Indian working class, see Radhakamal Mukerjee, The Indian Working Class, 3rd edition, Hind Kitabs Ltd., Bombay, 1951.

through mass commodity taxation will lead to increases in money wage-rates and to a consequent further rise in prices.

It might be argued that small increases in commodity taxation, or step by step increases spread over a period of years, will not lead to the results noted above. This may be true. But we are arguing only against substantial increases in mass commodity taxation to finance an ambitious program of development. Visiting experts often recommend an increase in tax revenues in underdeveloped countries. It is, however, never made clear that this increase should be brought about in ways that prevent, or at least minimize, increases in the price level. Since the extension of direct taxation is beset with many difficulties, the government of an underdeveloped country is strongly tempted to extend taxation of mass consumption. Discussion of possible inflationary effects is almost solely confined to the case of deficit financing. It is implicitly or explicitly assumed that, so long as increased expenditures are covered by increased taxation, no inflationary effects will be generated. This is obviously not true under all circumstances.

In recent years the general sales tax has attained popularity in advanced economies as an anti-inflationary measure. If money wages could be prevented from rising, increased sales taxation would certainly reduce purchasing power and cut down spending. And where the level of living of the vast majority of the population is above bare subsistence, it is at any rate theoretically possible to persuade the populace to accept a cut in standards of consumption.

But where a majority or even a large portion of the population lives on the margin of subsistence, the general sales tax is not likely to be equally effective as an anti-inflationary measure.

d. Distribution Effect. We come lastly to the distribution effect of commodity taxation. Economists have been long interested in the distributive effects of taxation, as indeed is even the man in the street. These effects have been traditionally held to depend on the incidence of particular tax measures, the incidence being taken to mean the "burden" (real or money) of the taxes falling on different individuals or income groups. Hence the preoccupation with incidence analysis. But since this analysis is usually in the nature of partial equilibrium theory, holding all other things as equal, the incidence and effects of public expenditure are not taken into account. The burden then means only the reduction in real income suffered by different people as a result of the tax measure alone, without counting the "benefits" of public expenditure. Some writers like Mrs. Hicks have objected to the ignoring of the effects of public expenditure in measuring the "burden" of taxation; for public expenditure not only can alter the incidence of taxes (by shifting supply and demand schedules) but also can alter the final disposition of real income in the community, since the benefits of public expenditure have to be included in consumption. Nevertheless, it has not been possible to integrate, in theoretical formulations, the redistributive effects of the tax and expenditure sides of governmental operations.

Thus in a recent study on incidence, Richard A. Musgrave observes: "The distributional impact of consumer services provided by the government free of direct charges is a different matter, requiring separate analysis."¹

If the benefits of public expenditures are ignored, it can be argued reasonably that the incidence of a general sales tax is regressive. Under realistic assumptions, the imposition of a general sales tax would result in a rise in prices. If the rise in prices is uniform and if there is no fall in factor incomes, the incidence of the tax is on the consumers, in proportion to their consumption expenditures. In practice, the rise in prices will not be uniform, some factor incomes will fall, and part of the tax might be absorbed in excess profits. To the extent these things happen, the tax will not be borne exactly in proportion to consumption expenditures. Besides, by introducing differential rates into the sales tax structure, the burden of the tax can be made somewhat progressive with respect to consumption expenditure. Luxuries can be taxed at high rates and necessities at low rates. This will make the tax broadly progressive as between the rich and the poor in respect of incomes spent on consumption. At any rate, in respect of total incomes, the burden of the sales tax will be regressive because, as income increases, a larger proportion of it will ordinarily be saved.

¹In "General Equilibrium Aspect of Incidence Theory," American Economic Review, Vol. XLIII, No. 2, May 1953, p. 506.

Against the regressivity of the sales tax must be set the benefits of public expenditure. When taxation is used as a tool for promoting economic development, the incidence of benefits can be expected to be progressive. The incidence of benefits will depend on the pattern of investment. If priority is assigned to increasing the supply of wage-goods, the poorer sections can improve their economic position over time and the volume of employment can expand steadily. In fact, if over-all control over the pattern of investment is exercised by the government, which, in addition, also undertakes a large volume of investment, the economic positions of different classes, in the long run, will be dependent more upon investment policies than upon tax policies. The extreme case of this sort, of course, is that of the Soviet Union. There it is not the turnover tax that has kept down the level of living of the masses, but the basic allocation of real resources according to the investment pattern laid down by the Gosplan. The turnover tax is merely a device to raise the monetary value of the available supply of consumption goods to the level of the expected monetary demand for them.

The other extreme would be a purely laissez faire economy in which the government refrained from all interference with the pattern of investment and undertook the provision merely of the minimum of public services. Let us assume that the benefits of these services accrue more or less equally to all the members of society. In this case, the pattern of investment will depend primarily upon the

market forces. Goods and services will tend to be produced in accordance with consumer preferences as revealed by money demand expressed in the market. The relative economic positions of individuals in so far as their consumption is concerned will then depend primarily upon the money incomes left to them after taxation, for it is these money incomes that determine the allocation of resources among different kinds and classes of goods. In such an economy, therefore, the incidence of taxation as such is of paramount importance. But when the government begins to control and modify the pattern of investment in the social interest, regardless of market forces, the pattern of money income distribution after taxes is no longer the sole determinant of the future relative real income positions of different classes. Although relative economic positions at any given time will depend upon money incomes, such positions over a period of time will depend upon the pattern of investment laid down by the government. It follows that a suitable investment policy can counterbalance to some extent at any rate the regressivity of commodity taxation. Therefore a careful scrutiny of investment policies is as important as the study of incidence.

IV. AN EXAMINATION OF SOME OF THE BASIC FEATURES OF THE INDIAN FISCAL SYSTEM

In this part, an attempt is made to examine some of the basic features of tax policy in India and to evaluate them in the light of the principles developed in the earlier sections of the thesis. This is to be understood more as an essay in the application of "theory" to certain selected fields of taxation than as a comprehensive study of the Indian tax system. Only the basic direct and indirect taxes are covered.¹ In the discussion of the tax structure special attention is paid to recent developments in the field of direct taxation. In the concluding section certain problems raised by the financing of the Second Five-Year Plan are considered briefly.

A. Structure of Taxation

1. Constitutional Provisions

The Constitution of the Republic of India is quasi-federal in character. There are three layers of government in India: the central,² the state and the local. The local governments are fully creatures of the respective State governments and as such are not taken notice of in the Constitution.

¹Discussion of the tariff is omitted because tariff policy raises so many issues not related directly to the main theme of this study.

²The Central Government is referred to as the Union Government.

The division of powers as well as of sources of revenue between the Union Government and the State governments is laid down in the Constitution.¹ Fairly wide tax powers are vested in the States, but residual powers of taxation belong to the Union.

Important taxes within union jurisdiction are as follows: taxes on income other than agricultural income; corporation tax; customs duties; excise, except on alcoholic liquors and narcotics; estate and succession duties other than on agricultural land; taxes on the capital value of assets (exclusive of agricultural land) of individuals and companies; stamp duties in respect of certain financial documents; and taxes on transactions in stock exchanges and futures markets.

Important taxes within the jurisdiction of the States are the following: land revenue; taxes on agricultural income; taxes on the sale and purchase of goods, except newspapers; taxes on lands and buildings; succession and estate duties in respect of agricultural land; excise on alcoholic liquors and narcotics; taxes on the consumption or sale of electricity; stamp duties except those specified in the Union List; and taxes on luxuries including entertainments, betting, and gambling.

¹Taxes within the Union jurisdiction and those within the jurisdiction of the States are enumerated, respectively, in List I and List II of the Seventh Schedule of the Constitution.

Article 286 of the Constitution forbids taxation by States of (a) imports into and exports from the territory of India; (b) inter-state trade; and (c) sales of goods declared by Parliament by law to be essential for the life of the community.

The Constitution contains also provisions for the distribution of certain revenues between the Union and the States. These provisions are intended to give flexibility to the tax system and to insure uniformity in taxation wherever needed. The most important of the provisions may be mentioned here. First, the income tax is to be levied and collected by the Union but is to be distributed between the Union and the States in a prescribed manner.¹ Second, some taxes are to be levied and collected by the Union but are assigned to the States within which they are leviable. These include succession and estate duties in respect of property other than agricultural land and taxes on the sale and purchase of newspapers. Third, Union excise duties, though levied and collected by the Union government, may be distributed between the Union and the States. Excises on tobacco, matches, and vegetable products are shared at present, in the proportion of 60:40 between the Union and the States.²

¹The "divisible pool" of income tax does not include the tax on the employees of the Union Government nor the corporation tax. At present 60 per cent of the divisible pool is assigned to the States.

²The Second Finance Commission has recommended recently that the duties on sugar, tea, coffee, paper, and vegetable non-essential oils also be shared; but the share of the States is to be brought down to 25 per cent from 40 per cent.

Finally, there are certain duties which are to be levied by the Union but are to be collected and appropriated by the States. These include stamp duties and duties of excise on medicinal and toilet preparations which are mentioned in the Union List.

There are no taxes which are constitutionally reserved for local bodies. The States may assign to them any of the taxes on the State List, either in whole or in part. The main taxes that are usually assigned to local bodies are property taxes, octroi¹ and terminal taxes, taxes on professions, and taxes on vehicles and animals.

2. Revenues of the Union and State Governments

In 1953-54, total current revenue of all governments was about Rs 8.7 billion, of which the Union and State governments accounted for Rs 3.9 billion and Rs 4.16 billion, respectively, or 45 per cent and 48 per cent of the total. The total tax revenue in that year amounted to Rs 7.12 billion or 81 per cent of the total revenue. Non-tax revenue thus formed around 18 per cent of the total revenue.

The ordinary revenues of the Central government increased by more than four and a half times from 1938-39 to 1953-54, and those of the nine Part A States² increased to a little over four times their pre-war level. Per capita tax contribution in money terms, also, registered a similar in-

¹An Octroi is a tax on the entry of goods into a local area.

²For some time after Independence, the States were divided into 3 categories: Part A, Part B, and Part C. Part A States were the former Provinces of British India; Part B States were the former Princely States; and Part C States were areas under the overall control of the Union Government. These distinctions have been abolished now.

crease. At the same time there was a four-fold rise in per-capita national income in money terms over the war and post-war years. This rise is attributable solely to the rise in prices. The conclusion seems inevitable that, broadly speaking and in real terms, there was very little addition to the national tax effort in the average from 1938 to the beginning of the Second Plan. The proportion of tax revenue to national income stood at 6.17 per cent in 1953-54.¹ This is, of course, very low when compared to over 20 per cent of national income taken in taxation in advanced countries.² The fact that the proportionate share of the government in national income did not rise in spite of the rise in money incomes, the rise in rates of taxation, and the introduction of new taxes shows that the Indian tax system has lacked income-elasticity--a serious defect.

According to the budget estimates for 1957-58, the total revenues of the Union and State Governments amounted to Rs 12.36 billion of which the Union Government received Rs 6.05 billion, and the States Rs 6.31 billion. Part of the increase since 1953 reflects the rise in prices and part of it increased taxation in recent years.

A breakdown of the total public revenues into important constituent items as of 1953-54 is given in Table V

¹See Table IV, p. 168.

²In 1952-53, the percentage of national income taken in taxation is estimated to have been: Australia 28.7, Denmark 23.5, France 31.0, Japan 21.4, the United Kingdom 35.5, and the United States 27.4. (E. Alexander Katz, "On National Tax Realities and International Tax Comparisons," Public Finance, Vol. XI, No. 4, 1956, Table 2, pp. 318-319.)

below. This breakdown reveals that taxes on income bring about 20 per cent of total revenues, while taxes on commodities form 45 per cent of the total. Thus the important role of indirect taxation is clearly seen. Land revenue does not occupy now so prominent a place in the structure as it did before World War II. It accounts for only 8 per cent of total revenue, as against 14 per cent in 1938-39.¹

It is difficult to say anything precise about the proportion of direct and indirect taxes to total tax revenue. The proportions will depend upon how we classify the different taxes. The TEC came to the conclusion that the share of direct taxation in total tax revenue was 24 per cent, presumably by excluding land revenue from direct taxes. The figures given by the Central Statistical Organization suggest that the percentage was around 33 for 1953-54.² Whatever the exact figure may be, it is obvious that direct taxes on income and wealth play a much less important part in India than in a developed country such as the United States.³ The fundamental reason for the relatively low yield of direct taxation is the fact that there are formidable difficulties in using income tax as an instrument of mass taxation in an underdeveloped country. But there are also other reasons such as inadequate tax methods and large-scale evasion of income tax.

¹TEC Report, Vol. I, p. 18.

²Estimates of National Income, op. cit., p. 4, Table 3.

³The corresponding figure for the United States is around 75 per cent. This is on the assumption that the corporate income tax is not shifted.

Table IV
 SHARE OF GOVERNMENT IN DOMESTIC PRODUCT
 AND EXPENDITURE--PERCENTAGE DISTRIBUTION
 (India 1953-54)

	Per Cent of Total
Government's Share in the Generation of Net Domestic Product	
1. Net Output of Government Enterprises	3.00
2. Net Output of Government Administration	4.70
3. Net Output of the Private Sector	92.30
Government's Share in National Expenditure	
4. Government Administration: current expenditure	5.80
5. Government Administration: capital expenditure	1.20
6. Government Enterprise: capital expenditure	1.90
Government's Draft on Private Income	
7. Direct Taxes	2.30
8. Indirect Taxes	4.40
9. Miscellaneous Fees, etc.	1.00

Source: Estimates of National Income, op. cit., p. 5,
 Table 3.1.

Table V
COMBINED CURRENT REVENUES OF CENTRAL STATE
AND LOCAL GOVERNMENTS
(1953-54)

	Millions of Rupees
Union Taxes on Income Other Than Corporation Tax	1266.0
Other Taxes on Income	44.0
Corporation Tax	<u>384.0</u>
	1694.0
Customs	
Central	1600.0
State (inter-state transit duties)	64.6
Excise Duties	
Central	935.5
State	444.0
General Sales Tax	572.5
Sales Tax on Motor Spirit and Lubricants	75.7
Other Taxes Chiefly on Consumption (a)	<u>216.6</u>
	3908.9
Land Revenue	697.2
Property Taxes	
State	18.3
Local	229.3
Other Taxes and Duties (b)	<u>569.1</u>
Total Tax Revenue	7116.8

(continued on page 171)

Table V
COMBINED CURRENT REVENUES OF CENTRAL STATE
AND LOCAL GOVERNMENTS
(1953-54)

(continued from page 170)

	Millions of Rupees
Total Tax Revenue (figure carried forward from page 170)	7116.8
Public Utilities and State Undertakings	375.8
Other Revenues (c)	<u>1206.5</u>
Total Current Revenues	8699.1

Source: TEC Report, Vol. I, pp. 16-17, Table 3.

Notes: The figures given above are revised budget estimates.

- (a) Include tobacco duties, electricity duties, entertainment duties, tax on passengers and goods, octroi, and terminal taxes.
- (b) Include stamps, registration, motor vehicles taxation, betting tax, excise tax on sugar cane, etc.
- (c) Receipts under civil administration, debt services, civil works, and other miscellaneous and extraordinary items. Civil administration receipts account for major share.

The current revenues of the government of India in 1956-57, according to sources, are given in Table VI. Total revenue stood at Rs 5.62 billion and total tax revenue at Rs 4.95 billion. The tax revenues of the Union Government are derived mainly from three tax heads: Union excise duties, customs, and taxes on income. Until recently, customs were

the largest single source of revenue for the Central government. Significantly, now this position has been taken up by excise duties. Customs, once the mainstay of Central revenues, have been steadily losing their relative importance over the years and especially since the 'thirties. The policy of protection adopted by the government, import control during and after World War II, and the growth of indigenous industries have combined to reduce the volume of imports of consumer goods, while imports of capital goods are taxed only lightly. Hence the decline in customs revenue. The policy has been to replace this loss in revenue by increased excise taxation.

As of 1956-57, excise duties (including States' share) brought 38 per cent, customs 35 per cent, and taxes on income 26 per cent, of the total tax collections of the Union Government. In absolute figures, the contributions of the respective sources of income were Rs 1.9 billion, Rs 1.7 billion, and Rs 1.3 billion.

Details of tax and non-tax revenues of State governments for the year 1956-57 are given in Table VII. It brings out clearly the important role of commodity taxes in the finances of the States. Of the total tax revenue of Rs 3667 million, taxes on commodities and services accounted for Rs 1805 million or nearly 50 per cent. The States rely mainly on three sources of revenue: taxes on commodities and services, share of Central income tax and excise, and land revenue. Grants-in-aid from the Union Government also contribute a substantial share of revenue.

As we have seen earlier, an excise on alcoholic liquor is within the jurisdiction of the States. All the States received substantial amounts of revenue from this source until 1937. From that date, as a result of the policy of Prohibition adopted by an increasing number of States, the revenue from this source has been declining steadily. Its place has been taken up by the sales tax, which is now being levied by all the States. This is an outstanding development in the sphere of States' finances. In 1956-57 the total yield from sales taxation for all States was Rs 706.6 million, constituting about one-fifth of their total tax revenue.¹ The sales tax is the main elastic source of revenue possessed by the States and is expected to increase its yield as it comes to be developed in some of the States that have taken to it lately.

Land revenue has lost much of its former importance. Before World War II, it was by far the largest single source of revenue for the nine Provinces, forming as much as 45 per cent of their total tax revenue; earlier, in 1921-22, it made up as much as 50 per cent of provincial revenues.² By contrast, in 1956-57 land revenue brought only about 25 per cent of the total tax revenue of all States.

¹See Table VII.

²TEC Report, Vol. I, p. 26.

Table VI
REVENUE AND EXPENDITURE OF THE GOVERNMENT
OF INDIA IN 1956-57
(Revised Budget Estimates)

	Millions of Rupees
Revenue	
1. Taxes on Income	1308.5
(a) Taxes on Income Other Than Corporation Tax	(1413.6)
Less States' Share	(587.5)
Net Receipts	826.1
(b) Corporation Tax	482.4
2. Taxes on Commodities and Services	3612.6
(a) Customs	
Imports	1385.0
Exports	277.0
Other Revenue	68.0
Less Refunds	20.0
Net Receipts	1710.0
(b) Union Excise Duties	1887.3
(c) Other Taxes and Duties	15.5
3. Taxes on Property and Capital Transactions	26.3
(a) Estate Duty	25.2
Less States' Share	24.1
Net Receipts	1.1
(b) Stamps and Registration	20.1

(continued on page 175)

Table VI
REVENUE AND EXPENDITURE OF THE GOVERNMENT
OF INDIA IN 1956-57
(Revised Budget Estimates)

(continued from page 174)

	Millions of Rupees
(c) Land Revenue	5.1
4. Total Tax Revenues	4247.6
5. Administrative Receipts	181.7
6. Net Contribution of Public Undertakings	301.7
7. Other Revenue	187.4
8. Total Revenue	5618.4
Expenditure (on revenue account)	
1. Direct Demand on Revenue (of which States' share of excise)	332.9 (182.2)
2. Civil Administration	393.1
3. Defense Services	2029.5
4. Debt Services	382.1
5. Pension and Superannuation	89.8
6. Miscellaneous	482.8
7. Development Services	1200.9
8. Contributions and Miscellaneous Adjustments Between Union and State Governments	296.0
9. Other Expenditure	31.9
10. Total Expenditure	5239.0
Surplus	379.4

Source: Reserve Bank of India Bulletin, June 1957, pp. 529-30, Statement I; adapted.

B. The Composition of Public Expenditure

The breakdown of total current expenditures of all governments for 1953-54 is given in Table VIII. It will be seen that a substantial part of the expenditure, about 60 per cent, is incurred on Defense, Administrative items, Debt Services and collection charges. In Indian usage, these items are called non-developmental items. Social services absorb around 20 per cent of total current expenditure, while economic development and analogous functions take up about 21 per cent. National Defense alone is responsible for a little over one fifth of the total, and general administrative expenses come to 19.5 per cent. Education (8.8 per cent) is the major item in social services. As regards the outlay on economic development, a substantial part is on Civil Works (roads, bridges and buildings).

Current expenditure of the Union Government for the year 1956-57 is given in Table IV, and the combined current expenditure of all State governments, for the same year is given in Table IX. A larger proportion of the States' current expenditure is on development than the Union's. We find that developmental expenditure forms only about 37.5 per cent of the total expenditure (on current account) of the Union Government; whereas it forms around 59 per cent of the total current expenditure of the State governments.¹

¹Cf. Tables IV and IX. The figure for the developmental outlay of the Government of India is arrived at by adding items 6, 7, and 8 on the expenditure side of Table IV.

Table VII
TAX AND NON-TAX REVENUES OF STATES
(1956-57)

	Millions of Rupees
Tax Revenue	
Share of Income Tax	535.1
Agricultural Income Tax	57.3
Profession Tax	<u>0.9</u>
Total Taxes on Income	593.3
Estate Duty	23.8
Land Revenue	926.6
Stamps and Registration	299.0
Urban Immovable Property Tax	<u>19.4</u>
Total Taxes on Property and Capital Transactions	1268.8
Union Excise	170.4
State Excise	427.6
General Sales Tax	706.6
Sales Tax on Motor Spirit	87.3
Entertainment Tax	65.3
Electricity Duties	58.1
Motor Vehicles Tax	149.8
Other Taxes and Duties	<u>140.1</u>
Total Taxes on Commodities and Services	1805.2
Total Tax Revenue	3667.3

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Table VII
TAX AND NON-TAX REVENUES OF STATES
(1956-57)

(continued from page 177)

	Millions of Rupees
Non-Tax Revenue	
Administrative Receipts	667.0
Net Contributions of Public Enterprises	348.8
Other Revenue	435.7
Grants-in-Aid and Other Contributions	<u>651.0</u>
Total Non-Tax Revenue	2102.5
Total Revenue	5769.8

Source: Reserve Bank of India Bulletin, August 1957; adapted.

Note: The figures in the table are budget estimates.

Table VIII
TOTAL CURRENT EXPENDITURE OF ALL GOVERNMENTS
(1953-54)

	Millions of Rupees	Percent of Total
I. Non-Development		
Direct Demands on Revenue	432.7	4.67
Interest on Debt and Other Obligations	485.4	5.24
Debt Retirement	146.4	1.50
National Defense (net)	1996.9	21.54

(continued on page 179)

Table VIII

TOTAL CURRENT EXPENDITURE OF ALL GOVERNMENTS
(1953-54)

(continued from page 178)

	Millions of Rubees	Percent of Total
General Government		
External Affairs	45.1	0.49
General Administration	578.7	6.24
Administration of Justice	113.4	1.22
Jail and Convict Settlements	77.7	0.84
Police	572.3	6.17
Others	420.2	4.53
Miscellaneous	<u>649.3</u>	<u>7.01</u>
Sub-Total of Group I	5518.1	59.53
II. Social Services		
Education	813.3	8.77
Public Health	166.5	1.79
Medical	292.9	3.16
Others	<u>545.5</u>	<u>5.88</u>
Sub-Total of Group II	1818.2	19.60
III. Economic Development		
Agriculture	276.7	2.99
Veterinary	48.6	0.52
Co-operation	59.0	0.64
Community Development Projects	103.7	1.12
Irrigation and Forests	256.7	2.77

(continued on page 180)

Table VIII
TOTAL CURRENT EXPENDITURE OF ALL GOVERNMENTS
(1953-54)

(continued from page 179)

	Millions of Rupees	Percent of Total
Electricity Schemes	14.9	0.16
Industry and Supplies	263.3	2.84
Civil Works	799.1	8.60
Others	<u>110.9</u>	<u>1.20</u>
Sub-Total of Group III	1932.9	20.85
Grand Total	9269.2	100.0

Source: TEC Report, Vol. I, pp. 244-45; adapted.

Table IX
DEVELOPMENT AND NON-DEVELOPMENT EXPENDITURES
OF STATES--1956-57
(Revenue Account)

	Millions of Rupees
Development Expenditure	
Education	1199.3
Medical and Public Health	542.7
Agriculture Veterinary and Co-operation	466.6
Irrigation	229.3
Electricity Schemes	91.4
Rural and Community Development Projects	329.7

(continued on page 181)

Table IX
DEVELOPMENT AND NON-DEVELOPMENT EXPENDITURE
OF STATES--1956-57
(Revenue Account)

(continued from page 180)

	Millions of Rupees
Civil Works	599.2
Industries and Supplies	197.7
Other Expenditure (a)	<u>215.6</u>
Total Development Expenditure	3871.5
Non-Development Expenditure	
Direct Demands on Revenue	558.1
Debt Services	230.8
Civil Administration	1280.4
Miscellaneous (b)	261.8
Famine	34.9
Other Expenditure (c)	<u>306.4</u>
Total Non-Development Expenditure	2672.4
Total Expenditure	6543.9
Source:	<u>Reserve Bank of India Bulletin</u> , August 1957, p. 746, Table 6; adapted.
Notes:	The figures are budget estimates.
	(a) Includes expenditure on scientific departments, aviation, and ports and pilotage;
	(b) Includes expenditure on displaced persons, grants and other contributions to local bodies and private parties, irrecoverable loans and advances, advanced technical training, scholarships, etc.
	(c) Includes pensions, stationery and printing, extraordinary charges, and transfers to funds.

The greater part of capital outlay by the Union and the States naturally is for developmental purposes. In 1956-57, the total capital outlay by the Union Government was Rs 3.14 billion, of which developmental outlay accounted for Rs 2.49 billion.¹ In the same year, the total capital outlay of the States was Rs 3.18 billion, of which developmental outlay accounted for Rs 3.16 billion.²

C. Taxation of Income and Wealth

The more important taxes on income and wealth are levied by the Union Government. Constitutionally, the States have the power to levy taxes on agricultural income and estate duties in respect of agricultural land. These taxes, however, are not important from the revenue point of view. Further, not many States have thought fit to levy the estate duty on agricultural land. The taxes on income and wealth that we must consider, therefore, are primarily those levied by the Union Government.

The Union Government now levies the following income and capital taxes: personal income tax, corporation tax, the estate duty, expenditure tax, annual tax on wealth, and gift tax. The gift tax is intended, as in the United States, to supplement the estate duty. The expenditure tax and the annual tax on wealth, on the other hand, are intended to supplement the income tax. Of these taxes, only the income

¹Reserve Bank of India Bulletin, April 1957, p. 334.

²Reserve Bank of India Bulletin, August 1957, p. 748.
There is some duplicating involved because a part of States' outlay is financed by grants from the Union.

and corporate taxes have been in existence for a fairly long time. The estate duty was introduced in 1953. The other taxes have been introduced only within the last two years, largely on the recommendation of Mr. Kaldor, who was called in as a consultant to the Government of India in 1956. These several taxes are supposed to form an integrated whole and are considered by their advocates as adequate measures of taxation for a developing economy. In what follows, we will first consider these taxes individually, in turn, and then discuss them as an inter-related system of taxation in the light of the principles evolved in the earlier sections of this thesis.

1. Personal Income Tax and the Corporation Tax

a. Taxes on Personal Income. The income tax is a fairly old tax in India. It was first imposed in 1860 but was abolished after a short time. It was reimposed in 1886 and has been in existence ever since. In the last 70 years or so the structure of the tax has undergone a series of changes. Today the income tax is a major source of revenue and one in which both the Union and the State governments are vitally interested. In its present form, it is comparable to income taxes in economically more developed countries of the world.

The personal income tax is levied on the net income of all individuals, joint Hindu families,¹ unregistered firms,

¹A joint Hindu family is one in which the "family property" is held in common.

and "other associations of persons."¹ Agricultural income and capital gains are not included in taxable income. Incomes of certain institutions like co-operative societies and religious and charitable trusts are exempted from taxation.²

The Indian Income Tax Act lays down the rules for arriving at net income from gross income. As regards deductions in respect of business incomes, the Act provides that all expenses that are "wholly and exclusively laid out or expended for the purposes of business" and that are not of a capital nature can be deducted.³ Depreciation is granted according to the written-down value method.

The basic exemption limit is Rs 3000 for individuals and Rs 6000 for joint Hindu families. All incomes above the exemption level are subject to the income tax. A super tax is levied in addition on all incomes above Rs 20,000. The rates of the super tax are much higher than those of the income tax. Under the Indian system, the individual is the unit of assessment. A wife is taxed separately on her work-income, but her investment income is treated as part of the income of her husband unless it can be proved that it is related to savings from her income or from her dowry. Some slight concession, however, is shown to married persons from

¹Not including limited companies or corporations.

²Only the business profits of cooperatives are exempted; as regards charitable and religious trusts, only income derived from property held under trust and from contributions is exempted.

³The Indian Income Tax Act, Section 10 (2).

1955-56. Whereas the tax-free slab is Rs 1000 for an unmarried individual, it is Rs 3000 for a married individual. But this marriage allowance of Rs 2000 is not applicable to incomes above Rs 20,000. In 1957-58, a child allowance of Rs 300 per child, subject to a maximum of Rs 600, was introduced. This again is applicable only to incomes up to Rs 20,000.

Other abatements and allowances also are granted under the Indian income tax system. First, there is provision for earned income relief. This used to be granted in the form of an allowance of 20 per cent, subject to a maximum of Rs 4000, for earned incomes not exceeding Rs 25,000. For incomes in excess of this amount, the allowance of Rs 4000 was progressively reduced, so that for an earned income of Rs 45,000 the allowance was reduced to nil.¹ From 1957-58, the relief is given in the form of a lower surcharge on earned incomes than on unearned incomes. Second, a rebate on income tax (but not on super tax) is granted for investment in provident funds and for payment of insurance premiums up to one-fourth of the total income subject to a maximum of Rs 8000. Third, an abatement is granted at the average rate of tax applicable to an assessee in respect of donations to approved religious and charitable institutions, which cannot exceed Rs 100,000 a year nor 5 per cent of the assessee's income. Finally, the interest on the National Plan Savings Certificates and Treasury Savings Deposits Certificates is exempted

¹This allowance did not apply to super tax.

from taxation.

Both the income tax and super tax are levied at graduated rates. The rates of taxation in force from April 1957 are given in Tables X and XI.

Table X
RATES OF INCOME TAX

Slabs of Income	Rates (per cent)
First Rs 3000 of Total Income	Nil
Next Rs 2000 of Total Income	3
Next Rs 2500 of Total Income	6
Next Rs 2500 of Total Income	9
Next Rs 2500 of Total Income	11
Next Rs 2500 of Total Income	14
Next Rs 5000 of Total Income	18
On Balance of Total Income	25

Source: Reserve Bank of India Bulletin, June 1957, p. 539; adapted.

Note: The above rates are applicable to married individuals and joint Hindu families. In the case of unmarried individuals and unregistered firms, the first Rs 1000 is tax free. The next Rs 4000 bears a tax of 3 per cent. After this level, the rates are the same as for married persons.

It will be seen from the Tables that the maximum rate of income tax (25 per cent) is made applicable above the level of Rs 20,000 and that the maximum rate of super tax (45 per cent) is made applicable above the level Rs 70,000. At present a surcharge on these basic rates also

is being levied. The surcharge on earned incomes is 5 per cent up to Rs 100,000 and 10 per cent on incomes above that level; while the surcharge on unearned incomes is 20 per cent. There is no surcharge when the total income is less than Rs 7,500. The income tax, super tax, and surcharge together result in a marginal rate of 84 per cent on the highest slab of unearned incomes, and of 77 per cent on the highest slab of earned incomes. The effective rates of taxation paid at selected income levels are given in Table XII.

Table XI
RATES OF SUPER TAX

Slabs of Income	Rates (per cent)
First Rs 20,000 of Total Income	Nil
Next Rs 5,000 of Total Income	5
Next Rs 5,000 of Total Income	15
Next Rs 10,000 of Total Income	20
Next Rs 10,000 of Total Income	30
Next Rs 10,000 of Total Income	35
Next Rs 10,000 of Total Income	40
Next Rs 10,000 of Total Income	45
Next Rs 10,000 of Total Income	45
Next Rs 10,000 of Total Income	45
Next Rs 20,000 of Total Income	45
Next Rs 30,000 of Total Income	45
On Balance of Total Income	45

Source: Reserve Bank of India Bulletin, June 1957, p. 539; adapted.

Note: The rates are applicable to all individuals, joint Hindu families, and unregistered firms.

Table XII

TAX PAYABLE IN SELECTED CASES AS PERCENTAGE OF INCOME

Income Rs	Tax Paid As Percentage	
	Wholly Earned	Wholly Unearned
3,000	----	----
3,600	2.2	2.2
5,000	2.4	2.4
10,000	5.2	5.9
12,000	6.3	7.1
15,000	7.8	8.9
20,000	10.6	12.1
30,000	19.3	22.0
40,000	26.3	30.1
50,000	35.3	40.4
100,000	51.5	58.8
500,000	71.9	78.9
1,000,000	74.4	81.5

Source: Reserve Bank of India Bulletin, June 1957, p. 540; adapted. These rates are applicable to unmarried persons. The rates applicable to married persons are only slightly different. Income tax, super tax, and surcharges have been included.

b. Company Taxation. Incomes of companies (i. e., corporations) also are subject to income and super taxes. The super tax on companies is levied on the net profits of a corporation at a flat rate of 20 per cent. This is in reality a corporation tax, since the stockholders are not

given credit for super tax paid by the corporation. In addition, the corporation pays an income tax on its profits at a flat rate of 30 per cent (plus 5 per cent surcharge); however, the income tax paid is deducted from dividends and is credited against the tax liabilities of the respective stockholders.

An additional super tax in the nature of an excess dividends tax has been levied on companies from April 1956. The additional tax is payable if dividends distributed are in excess of 6 per cent of paid-up capital. The tax is based on the excess amount distributed and the rates range from 10 to 30 per cent. This excess dividends tax is supposed to encourage corporate savings. As part of this measure, the Government has found it necessary to levy a tax on the issue of bonus shares. This is calculated to prevent companies from issuing bonus shares just to increase their paid-up capital with a view to evading the excess dividends tax.

Strangely enough, this policy is the very opposite of the one being pursued in respect of closely held corporations.¹ The owners of such corporations tend to keep a large part of the profits undistributed in order to avoid high personal taxation. Also, incorporation becomes a means of tax avoidance. "Everybody from a peer downwards converts himself into a private company." To plug these loopholes,

¹For tax purposes, a closely held corporation is defined to be one in which 60 per cent or more of the shares are held by 6 or less than 6 persons (Income Tax Act, Section 23-A).

the tax laws of most of the advanced countries contain special provisions concerning closely held corporations. In India the following rules apply to such corporations: The penal tax is 25 per cent of the undistributed dividends in excess of the prescribed maximum in the case of all companies other than investment companies, and 50 per cent in the case of the latter. In the case of industrial companies, the percentage of available profits which they should distribute so as to avoid the penal tax is 40; in the case of non-industrial companies, it is 60; and in the case of investment companies, it is 100.

It will be clear from the above account that, for an underdeveloped country, the taxation of company profits is pretty stiff in India. It must be pointed out, however, that important concessions and allowances are granted to businesses to promote corporate and business investment. From 1949, new industrial undertakings are exempt from income and super tax, for the first five years after the commencement of operations, on that part of their profits which is not in excess of 6 per cent of the capital employed. From 1955, a development rebate of 25 per cent is granted for all investments in plant and machinery installed for business purposes. Further, additional depreciation allowances equal to normal ones are allowed in respect of all investments in plant, machinery, and buildings for the first five years after the investment concerned.

c. Evaluation of Taxes on Income. The basic structure of Indian income tax was built on the British model

during the days of British administration. There has been no fundamental change in the income tax system after the transfer of power to Indian hands. It is true that other direct taxes have been added to the income tax in recent years, but the basic structure of income taxation itself has remained unaltered. When the tax was developed in India, economic development was not the dominant aim of public policy. Nor is the British pattern of income taxation suited to the very different conditions prevailing in India. One would have expected, therefore, that steps would have been taken after Independence to reform the system of income taxation. A Taxation Enquiry Commission indeed was appointed in 1953, and in 1955 Mr. Kaldor was called in as a consultant to suggest reforms in the tax system. But neither the TEC Report nor the Kaldor Report has led to any far-reaching changes in the taxation of income. For his part, Mr. Kaldor set out to introduce fundamental changes in the structure of direct taxation. In acting on his recommendations, however, the Government of India merely added new measures of direct taxation, while leaving almost intact the structure of income taxation.

The Indian income tax is a highly progressive tax on the total net incomes of individuals. It does not contain any comprehensive scheme for the promotion of personal savings. We have argued in an earlier section that partial exemption should be granted to savings. The present Indian tax does contain some provisions to this effect, but they are far from adequate. As far as personal non-business in-

come is concerned, the only provision for the encouragement of savings is the rebate on income tax given for investment in provident funds and for payment of life insurance premiums. The exemption from tax is granted up to one-fourth of the income subject to a maximum of Rs 8000. Only a minority of income earners contribute to provident funds in India. Further, as contributions to provident funds are compulsory (and fixed in amount) in many cases, they will be made even without tax concessions. Hence the concession regarding provident fund contributions does little more than give some relief to low-income groups. The allowance in respect of insurance premiums provides some encouragement to one form of savings. The effectiveness of this allowance, however, is limited by the fact that if new policies are taken up in a year to take advantage of the tax exemption, payments must be kept up in the succeeding years. Many taxpayers may be either unwilling or unable to do so. If the income of the taxpayer is exceptionally high in one or two years, he cannot take up new policies unless he can be certain that the higher level of income will continue for a number of years. Also, insurance policies lock up funds for a fairly long period, whereas funds invested in securities can be recovered by the disposal of securities in the market. Above all, there is need to encourage investment in equities and long-term government bonds. The present provision does nothing to this effect.

For these reasons, it must be said that the existing provision for the encouragement of personal savings is inadequate. It is suggested that partial exemption must be

granted to investments in equities and government bonds on the lines explained earlier.

In the case of business taxation, the Indian system contains some effective provisions to encourage private investment. First of all, there is the development rebate. This is a convenient way of encouraging the ploughing back of profits and lessening the difficulties of replacement in times of rising prices. It is also a useful counter-cyclical weapon in so far as capital expenditure by businesses can be influenced by changes in the rate of development rebate. However, since it is a costly device, it must be used sparingly. At present the rebate is applicable to all types of businesses. There is a strong case for restricting its applicability to certain industries of national importance.¹

Secondly, the profits of new industrial undertakings, up to 6 per cent of capital employed, are exempted from taxation for a period of 5 years. It has already been argued in Part III, Section B that this is not a desirable device to encourage investment. It is much better to grant exemptions as and when investments are made. The development rebate as well as the scheme of exemptions proposed in this thesis provide for this type of encouragement. One further argument against the exemption of the profits of new concerns is that it is not of any appreciable benefit to the concerns when accelerated depreciation also is granted. Additional depreciation allowances, equal to the normal ones, are granted at present for a period of five years. Double depreciation by

¹ The TEC was of this opinion; see TEC Report, Vol. II, p. 99.

itself reduces tax liability considerably, often eliminating it, in the earlier years when profits are likely to be low. There does not seem to be any case for an additional measure to help new industrial undertakings.

The rates of progression of the Indian income tax are comparable to those obtaining in more developed countries of the world. The TEC compared the rates in India with those in a number of advanced countries.¹ It found that the initial marginal rates comparatively were low in India but that the marginal rates after the level of Rs 25,000 rose rather steeply and were among the highest in the world. The highest marginal rate (inclusive of surcharge) was 82 per cent at the time of the Commission's study. Subsequently the rates were raised above the level of Rs 70,000 as also in the middle-income ranges. Now the highest marginal rate is 84 per cent.² Therefore the Commission's findings still hold good. In view of the fact that the rates in the top brackets already are high, there is not much scope for raising them. On the other hand, it will be seen from Table XII that the effective rates of taxation are below 25 per cent up to the level of Rs 30,000. These rates might bear some increase. However, two conditions must be fulfilled before the rates justifiably can be raised. One is that a partial exemption for

¹TEC Report, Vol. II, p. 133.

²In 1955, the highest marginal rate was raised to 91.9 per cent on incomes above Rs 150,000. It was lowered in 1957 to 84 per cent in view of the levy of the expenditure tax.

savings must be introduced. The existing concessions are such as to benefit mostly the high-income business groups. Similar concessions must be made available to the middle-income groups and non-business groups before they are asked to pay higher rates of taxation. The second condition is that steps must be taken first to bring under charge considerable income that escapes taxation either because of the defects in the tax laws or through illegal evasion. Only after these steps have been taken will there be justification for asking people who are already paying taxes to pay more.

There is evidence to think that evasion of the income tax is practiced on a large scale in India. The TEC admitted that the statistics made available to it by the Central Board of Revenue led to the conclusion that evasion was prevalent on a considerable scale.¹ Statistics concerning cases of disclosed evasion showed that the difference between the income originally returned and that disclosed later to the income tax department was, on the average, as much as 600 per cent.² Commenting on this fact, the TEC said: "When it is remembered that these statistics are of attempted evasion, which has been detected by the Income Tax Department, and allowance is made for the fact the Income Tax Department is ill-equipped in the matter of trained staff to cope adequately with the problem of evasion, the quantum of evasion which actually takes place and goes undetected could rightly be

¹TEC Report, Vol. II, p. 189.

²Ibid.

estimated at a very high figure indeed."¹ Kaldor estimated that annually Rs 5.76 billion of income evaded tax and that the magnitude of tax lost through evasion was in the neighborhood of Rs 2 to 3 billion.² The Central Board of Revenue has questioned Kaldor's figures; its own estimate is that the amount of income that evades tax is around Rs 2.24 billion.³ Even if one accepts the lower estimate, the extent of evasion must be deemed enormous because the total income assessed to tax was only Rs 7.85 billion in 1955-56 and Rs 9.36 billion in 1956-57.

The TEC felt that the problem of evasion could be tackled effectively only by improving and strengthening the enforcement machinery. It recommended several measures towards this end.⁴ The most important suggestion made by Kaldor is that the taxpayers in the higher-income groups should be asked to submit a comprehensive return showing the assessee's income, expenditure, capital transactions, and net worth.⁵ The reforms suggested by the TEC and Kaldor certainly are worthy of serious consideration. However, it must be pointed out that both of them completely neglected one aspect of the problem of evasion that is peculiar to India. A large number of people in the lower and middle brackets completely escape taxation because they keep no regular

¹ *Ibid.* Italics in the original.

² Kaldor Report, p. 103.

³ Mentioned in D. T. Lakdawala, *op. cit.*, p. 201.

⁴ TEC Report, Vol. II, pp. 353-355.

⁵ Kaldor Report, pp. 53-61.

accounts and present no concrete evidence of being liable to taxation in terms of the existing provisions of the Income Tax Act. Prima facie evidence of this statement is provided by the following figures. The total number of assessments to income tax is only around 600,000.¹ Even granted that agricultural incomes are excluded from income tax, the figure of less than a million assesseees is ridiculously low. Of the 499,621 individuals assessed in 1956-57, non-salary earners and salary earners with incomes from other sources amounted to 317,485.² It is impossible to believe that the total number of merchants and moneylenders liable to income tax in the whole of India, that is, with a net income not less than Rs 250 per month, is less than 320,000. There can be no doubt that a considerable number of these categories of earners, especially those living in semi-urban and rural areas, are completely escaping income taxation.³

In order to check this evasion, the income tax law would have to be amended. In the case of traders and moneylenders who do not keep regular accounts, the law could provide assessment by the old method of presumption. An alternative method also has been suggested. "For self-employed shop-keepers a schedular system might be devised whereby taxes may be assessed as a fixed percentage of turn-

¹The total number of assessments completed during 1956-57 was 923,265; but in the case of 272,982 assessments, there was no tax demand. (See Reserve Bank of India Bulletin, April 1958, p. 397.)

²Ibid., p. 398.

³Further evidence of this is shown at a later stage.

over, unless the person produces books to show that the tax would be lower if based on net income."¹ A suitable device, embodying either one of the principles suggested above, to deal with the cases of self-employed small traders and money-lenders is one of the most urgently needed reforms in India.

Unchecked evasion, of course, violates the principle of horizontal equity. Besides this, the law itself may be so framed as to violate this principle. The law may--and often does--fail to treat equally people in similar circumstances. In India the exclusion of capital gains from the definition of "income" and of agricultural income from central income taxation are two important examples of failure to mete out even justice among individuals who enjoy equal accretions of economic power or beneficial receipts of income. We have argued earlier at some length that capital gains should be included in taxable income but that they should receive favorable treatment if re-invested. This is another important reform that must be effected as soon as possible.

As for agricultural incomes, their exclusion from Central taxation is only partially offset by the levy of agricultural taxes by a number of States. The rates in most cases are lower than the Central rates. Even if the rates are raised by the States, the splitting of the total income of an individual into agricultural and non-agricultural income inevitably has the effect of lowering the average rate

¹Economic Bulletin for Asia and Far East, Vol. IV, No. 3, November 1953, p. 9.

of tax. Besides, the present system opens up possibilities of evasion by taxpayers in States where no agricultural income tax is levied. When presented with evidence of higher income than declared, they could claim that part of it was derived from agriculture. The really effective solution would be for the States to delegate to the Union their power to tax agricultural incomes and then share the proceeds. (This already is done by a few States in respect of estate duty on agricultural land.) The increase in revenue resulting from such an arrangement is not likely to be considerable; for the abolition of the Zamindari¹ and other land reform measures are reducing substantially the number of high agricultural incomes. The reform suggested is more in the interest of equity than of revenue.

The present structure of company taxation in India is unnecessarily complicated, illogical, and devoid of any sound basic principle. No wonder Kaldor was led to remark: "The company taxation provisions of India (perhaps even more than that of other countries) are apt to **strike** a detached observer as a perfect maze of unnecessary complications, the accretion of years of futile endeavour to reconcile fundamentally contradictory objectives."² An analysis of the existing measures of company taxation will bear out the justness of Kaldor's remark.

¹Feudal proprietorships of land.

²Kaldor Report, p. 85.

The companies are subject to income and super taxes. The latter is levied at the rate of 20 per cent and is non-refundable. Hence it is a corporation tax analogous to the ones existing in other countries such as the United States. The income tax is payable by the companies at 30 per cent (plus 5 per cent surcharge) and is credited against the liabilities of stockholders. However, in paying the income tax, the companies do not act merely as collecting agents for the exchequer. The tax is payable whether or not any dividends are paid in a year. Even when dividends are declared, the income tax amounts to "deduction at the source" only as far as the distributed profits are concerned. The company as such has to bear the income tax on that part of the profits which is undistributed. Companies as separate entities then are required to pay two taxes: one on total profits and the other on undistributed profits. There seems to be no need for this additional tax on undistributed profits. Besides, under the present system, the amount of tax paid on distributed profits bears no close relation to the amount credited to the stockholders. "Often the shareholders were credited with much larger amount than the tax actually levied on the companies."¹

This system of company taxation penalizes the retaining of profits, because the company is forced to bear both the income and super taxes on retained profits. Having introduced such heavier taxation of undistributed profits, how-

¹D. T. Lakdawala, op. cit., p. 147.

ever, the Government granted for sometime a rebate of 6½ per cent on tax paid on undistributed profits! The rebate was abolished in 1956 and was "replaced" by the excess dividends tax described in an earlier section.

As the position stands now, companies pay a 20 per cent tax on distributed profits and a 50.5 per cent tax on undistributed profits. In addition, if the dividends are in excess of 6 per cent of paid-up capital, companies are subject to a tax on the excess amount of dividends the rates of which range from 10 to 30 per cent. It is not clear what the Government wishes to encourage--the retaining of profits or the distribution of dividends. We are able to draw only one definite conclusion, namely, that the Government is more interested in raising revenue than in any other objective.

Nor is this all. As already pointed out, closely held corporations (the so-called Section 23A companies) are subject to a penal tax if they fail to distribute a certain minimum percentage of available profits. Whatever justification there may be in forcing Section 23A companies to distribute a substantial portion of their profits, it obviously is a contradiction to subject them to the penal tax and the excess dividends tax at the same time. Some companies might find that if they sought to avoid the penal tax on non-distribution, they would become liable to the penal tax on excess distribution. Presumably, administrative orders could be issued to correct this situation in particular cases. However, the contradictoriness of these tax measures brings out clearly the lack of clear objectives in the framing of

tax policies.

It is suggested that the existing measures of company taxation must be reformed drastically. Company taxation must fulfill, as far as possible, the three objectives of raising revenue, preventing avoidance of tax through incorporation, and encouraging corporate saving. With these objectives in view, the following measures are recommended. Corporations per se should be required to pay only one tax, namely, the corporation tax to be levied at a flat rate. In addition, they could deduct at source the income tax on dividends as and when dividends are paid and thus assume merely the responsibility of collection. The stockholders would be given credit for the income tax deducted, but not for corporation tax paid. Companies should not be required to pay an excess dividends tax. However, in view of the great concentration of control observed in the case of Section 23A companies, the present penal tax on non-distribution will have to be retained.¹

It may be argued that if the present income tax on companies is removed, we shall be failing to tax adequately the retained profits of corporations and hence to reach the appreciations of capital enjoyed by stockholders. This argument is true only in the absence of a tax on capital gains. Under our scheme, capital gains are to be included

¹ A survey by TEC disclosed that 86 per cent of Section 23A companies were controlled by four or less than four persons each, and 30 per cent by one person only. (TEC Report, Vol. II, p. 177.)

in taxable income. Taxation of capital gains would take care of the appreciation of capital accruing to the stockholders, while the abolition of the extra tax on undistributed profits might encourage expansion through re-investment.

2. Taxes On Capital

Two important taxes on capital that we must discuss are the estate duty and the annual tax on wealth or net worth levied by the Union Government. It will be recalled that the Constitution reserves to the States the estate duty in respect of agricultural lands and the property tax. The latter is levied by local governments; as for the former, attempts are being made to integrate it within the structure of the Central duty.

a. Estate Duty. The estate duty was introduced in 1953. It is levied on property passing or deemed to pass on the death of a person. All property passing on the death of a person is aggregated to form one estate. Agricultural land situated in those States which have agreed to Central legislation will form part of the estate subject to duty. Agricultural land situated in other States is not subject to duty, but its value is to be taken into account for determining the rate of duty leviable on other property.

The exemption level is Rs 50,000. Estates above the exemption level, after the deduction of permissible allowances, are taxed at progressive rates. The rate schedule as of April 1958 is given in Table XIII. The highest marginal rate is 40 per cent on the slab above the level of Rs 5 million. The Estate Duty Act, 1953, contains provisions to

counteract attempts at legal avoidance. Gifts made "in contemplation of death" are treated as passing on death. Gifts inter vivos for public charitable purposes made within a period of six month before death and such gifts for other purposes made within five years before death also are treated as passing on death. On the other hand, gifts made in consideration of marriage and money earmarked for the marriage of dependent females are exempted from the tax up to a maximum of Rs 10,000. Almost the whole yield of the tax (which was around Rs 25.2 million in 1957-58)¹ is distributed among the States in accordance with constitutional provisions.

b. Annual Tax on Wealth. The tax on wealth was introduced May 1957, largely on the recommendations of Kaldor. It is imposed on the excess of net wealth over exemptions of individuals, joint Hindu families, and companies. Net wealth is arrived at by calculating the market value of the properties of an assessee and deducting all obligations. Certain types of properties are exempted completely from the tax. Notable among them are agricultural properties, properties belonging to charitable or religious trusts, works of art, personal effects (up to a maximum of Rs 25,000), and balances in provident funds and life insurance policies.

The exemption level is Rs 200,000 for individuals, Rs 400,000 for joint Hindu families, and Rs 500,000 for corporations. The corporations are taxed at a flat rate of $\frac{1}{2}$

¹Reserve Bank of India Bulletin, March 1958, p. 239, Table 2.

Table XIII
RATES OF ESTATE DUTY
(As of April 1, 1958)

Value of the Estate	Rate (per cent)
First Rs 50,000	Nil
Next Rs 50,000	6
Next Rs 50,000	8
Next Rs 50,000	10
Next Rs 100,000	12
Next Rs 200,000	15
Next Rs 500,000	20
Next Rs 1,000,000	25
Next Rs 1,000,000	30
Next Rs 2,000,000	35
On Balance	40

Source: Reserve Bank of India Bulletin, March 1958, p. 253, Appendix I; adapted.

per cent; for others, the rate is $\frac{1}{2}$ per cent on the first taxable slab of Rs one million, 1 per cent on the next Rs one million, and $1\frac{1}{2}$ per cent on the balance. When the tax was introduced in 1957, it was estimated that there would be about 36,000 assesseees, 6000 of whom would be companies. The yield of the tax in 1957-58 is estimated to be Rs 90 million.¹

¹Ibid.

c. Gift Tax. A tax on gifts was introduced in April 1958 as a complement to the estate duty and the wealth tax. The tax is payable by all donors except charitable institutions, government companies, and public companies. Certain kinds of gifts are excluded from the tax. Examples are gifts of savings certificates declared gift-tax free, gifts to charitable institutions, gifts to female dependents on the occasion of marriage (up to Rs 10,000), gifts to wife (up to Rs 100,000), and gifts under a will.

Subject to the exemptions provided, the tax will be charged if the total gifts made by a donor in a year exceed Rs 10,000. It will be assessed on the value of all gifts made by the donor during a year, but for the purpose of determining the rate applicable, the gifts made during the five previous years immediately preceding the financial year will be aggregated. The rates of tax are based on a slab system and vary from 4 per cent on the first slab of Rs 50,000 to 40 per cent on gifts over Rs 5 million. The schedule of rates is the same as for the estate duty except that the first slab of Rs 50,000 bears a tax of 4 per cent, instead of being exempt as under the estate duty.

The gift tax came into force on April 1, 1958. Another tax that came into operation on the same day is the expenditure tax. These two taxes together with the annual tax on wealth were all recommended by Kaldor as an integrated system of direct taxation. Hence it would be best to discuss and evaluate them together. Meanwhile, it is necessary to give a brief description of the personal expenditure tax.

3. Expenditure Tax

The personal expenditure tax is a direct personal tax payable by individuals and joint Hindu families. It is based on the expenditure incurred in the "previous year."¹ The tax is payable only if the spendable income of an individual or joint Hindu family, after the deduction of other direct taxes payable, is more than Rs 36,000 in the assessment year. This means that the income before payment of income tax should be more than Rs 60,000. The taxes deductible for arriving at spendable income include income tax, super tax, and wealth tax, but not expenditure tax, although for finding out the taxable expenditure the expenditure tax paid is deductible.

Many items of expenditure are tax-exempt and are deducted from total expenditure in order to arrive at taxable expenditure. These include business expenses, expenses on property, investments, repayment of loans, gifts, and insurance premiums. From the total non-exempt expenditure certain deductions are allowed, the most important of which are the standard or basic allowance of Rs 30,000 and an additional allowance of Rs 3000 for each additional coparcener² of the joint Hindu family. Other deductions include allowances for marriage expenses up to a maximum of Rs 5000 for each depend-

¹For example, the tax to be paid in 1958 will be based on the expenditure incurred in 1957.

²A coparcener is a member of a joint Hindu family who has a share in the joint property.

ent's marriage, allowance for parents' maintenance up to a maximum of Rs 4000, allowance for medical expenses subject to a maximum of Rs 5000, and expenditure on foreign education subject to a maximum of Rs 8000.

On the tax base arrived at after deducting all the applicable allowances, the expenditure tax is levied at rates that range from 10 per cent on the first Rs 10,000 of taxable expenditure to 100 per cent on taxable expenditure over Rs 50,000.

Taxable expenditure includes not only amounts actually spent by the assessee, but also any expenditure for which liability has been incurred by him. It includes also expenditure incurred by some other person on behalf of, and for the benefit of, the assessee, or his wife, or his children.¹ Another provision is that four-fifths of expenditure on certain consumer durables such as motor cars and furniture is exempt when it is incurred, but one-fifth of it is deemed to be incurred in each of the succeeding four years. This provision enables the spreading over of heavy expenditure on consumer durables.

Since the Expenditure Tax Act came into force only on April 1, 1958, the first year in respect of which the tax will be payable is 1957-58. In the budget estimates for 1958-59, credit is taken for a revenue of Rs 30 million under

¹However, such expenditure will be taken into account only to the extent that it exceeds Rs 5000 in a year.

the expenditure tax.¹ From the point of revenue, therefore, the tax does not seem to be of any great significance. It must be pointed out that only persons with a pre-tax income of Rs 60,000 are affected by the tax. It has been estimated that about 6000 assesseees would be liable to pay the tax.

4. Evaluation of the Wealth, Expenditure, and Gift Taxes

As mentioned earlier, these additional direct taxes have been imposed largely on the recommendations of Kaldor. It is, therefore, necessary for us to consider the arguments adduced by Kaldor in favor of his proposals as well as the reasons given by the Government of India in imposing the new tax measures.

a. Kaldor's Arguments. Kaldor's ideas on direct taxation have been expounded at length in his book An Expenditure Tax. For the most part his Report to the Indian Government seeks to apply these ideas to the Indian case. It must be remembered that Mr. Kaldor spent only about 3 months studying the Indian tax system. The most he could do at the limited time at his disposal was to adapt the ideas he had already formed on the subject to suit the needs of the Indian economy as he conceived them to be. The chief merit of Kaldor Report lies in the fact that its author brought a fresh and vigorous mind to bear upon the tax problems of a developing economy; and its chief weakness is that he had an insufficient knowledge of the economic and institutional facts of the country with which he was dealing.

¹Reserve Bank of India Bulletin, March 1958, p. 239, Table 2.

Kaldor supports his tax proposals on the grounds of equity, economic effects, and administrative efficiency.¹ According to him, from the point of view of equity, the most important consideration is that the tax system should not contain a bias in favor of particular groups of taxpayers; from the point of view of economic effects, the major consideration is that the tax system must be prevented from weakening unduly the incentive to work, save, and take risks; and from the point of view of administrative efficiency, the main requirements are simplicity and comprehensiveness, which make for ease of administration and at the same time prevent large-scale evasion. These are, of course, desirable principles of taxation and are akin to the ones we have put forward in this thesis.

Kaldor thinks that the usual type of income tax is very defective on all the three counts mentioned above: it is not levied in accordance with the real ability to pay of different taxpayers; it weakens the incentive to work, save, and bear risks; and, since it does not call for a comprehensive tax return, it opens up several ways of evasion. Kaldor is not, of course, the first economist to hold this opinion. Many other economists, from J. S. Mill to Irving Fisher, have criticised the income tax as being unfair and harmful. Kaldor's arguments closely follows theirs, and may be summarized as follows.

¹Kaldor Report, pp. 10ff.

If the tax is to be equitable, that is, to be fair as between different individuals in similar circumstances, it must be levied on a base that is a satisfactory index of the taxable capacity of the individuals. According to Kaldor, the present base of taxation, namely, "income" as statutorily defined in most countries, including India and Britain, is defective and biased.¹ It is not a true measure of "means" or "spending power" of different individuals. It is spending power, however, which is the true index of taxable capacity. The spending power of an individual in any given period of time depends on the wealth that he possesses, his "regularly recurrent receipts," and his casual receipts.² "Each of these three elements makes a distinct and separate contribution to a person's spending power ..." ³ To take the first, the possession of wealth per se endows an individual with taxable capacity which is not touched by the income tax. The second element consists of receipts which are ordinarily included in the concept of taxable income. The third element is represented by receipts like capital gains and gifts which are usually excluded from income taxation. Kaldor concludes that the net result of the exemption of many kinds of receipts from the definition of taxable income and of the neglect of the taxable capacity arising from the possession of wealth "is to introduce a systematic bias in taxation in favour of property owners, since the liability of occurrence of such

¹Ibid., p. 1.

²An Expenditure Tax, pp. 30-31.

³Ibid., p. 31.

casual or windfall gains is closely associated with the ownership of property ..."¹

Drastic changes in the tax system are needed if we are to render justice to all types of "income" earners. If the existing system of income taxation were supplemented by an annual tax on capital and if the concept of taxable income were extended to embrace all forms of wealth-accrual, we would get a much more equitable system of taxation than the usual type of income tax.

Having said so much, however, Kaldor puts forward the view that actually the accruals of spending power from various sources cannot be reduced to a common denominator except on some highly arbitrary basis.² Therefore, "no definition of Income, which is a plausible one for purposes of tax assessment, can measure taxable capacity."³ This means, on his showing, that we cannot at all have a satisfactory system of taxation based on "income" as such.

The income tax is not merely unsatisfactory from the point of view of equity, but is also harmful from the economic point of view.⁴ Kaldor employs the familiar argument about the "double taxation" of savings and says that the income tax discriminates against, and discourages, savings. Moreover,

¹Ibid., p. 36.

²For instance, \$100 of capital gain does not constitute the same amount of spending power as \$100 of regularly recurrent receipt.

³Ibid., p. 47.

⁴For Kaldor's discussion of the economic effects of income taxation see Ibid., Chapters II, III, and IV.

a highly progressive income tax has a tendency to reduce the incentive to work and bear risks. In all possible ways, therefore, the income tax would inhibit the growth of private enterprise but for the fact that the definition of taxable income is not comprehensive enough and that there are many loopholes for tax avoidance and evasion. Thus we avoid the worst economic consequences of a highly progressive income tax at the expense of equity.

Would it not be better, therefore, asks Kaldor, to levy a tax on a person's (consumption) expenditure, instead of on his income, however that may be defined? The tax authority would find it difficult to reduce accruals of spending power from various sources to a common denominator. "But each individual performs this operation for himself, when, in the light of all his present circumstances and future prospects, he decides on the scale of his personal living expenses."¹ Thus, when expenditure is made the basis of taxation, the problems created by the non-comparability of various types of accruals of wealth resolve themselves. This then is Kaldor's first argument in favor of an expenditure tax.

Kaldor argues that the expenditure tax has other merits. It does not discriminate against risk-bearing as does the income tax. It encourages savings and discourages dis-savings by the wealthy. Any economy based predominantly on private enterprise cannot afford to reduce the flow of

¹Ibid., p. 47.

private saving, which is precisely what would be done by a comprehensive type of income tax. Hence the expenditure tax is preferable on economic grounds too.

A progressive tax on personal expenditure, raises many administrative difficulties. Kaldor realizes that because of its administrative complexities the expenditure tax could never become a suitable instrument of mass taxation. Hence he has suggested that in the case of Britain the present surtax may be replaced by the expenditure tax, while the basic income tax will have to be retained. Similarly, in the case of India Kaldor's recommendation was that only the super tax be replaced by the expenditure tax. The income tax would continue to be levied. Kaldor suggested that the maximum rate of income tax should be around 45 per cent and that realized capital gains should be included in taxable income.¹ In point of fact, however, the Government of India, while accepting in a modified form his proposal of an expenditure tax, retained the super tax as well as the basic income tax and brought down the maximum rate of income taxation only to 84 per cent from the 1956 level of 91.9 per cent. Capital gains continue to be exempt from income taxation.

b. Arguments Against the Expenditure Tax. We agree with Kaldor on the urgent need to stimulate savings in the Indian economy. We agree also that the replacement of the present super tax by an expenditure tax would tend to encourage savings. But we are not all certain that the

¹Kaldor Report, p. 15.

expenditure tax is the best method to promote savings under conditions obtaining in India. Nor is it possible to accept all of Kaldor's arguments in favor of this tax.

First of all, the very complexity of administering the expenditure tax--admitted by Kaldor himself--seems to disqualify the tax for adoption by India at the present juncture when there is a grave shortage of trained revenue staff. Currently, income tax collections are in great arrears. The income tax department is ill-equipped even to administer the income tax efficiently enough to prevent large-scale evasion. It does not, therefore, seem opportune to introduce an entirely new tax, as yet untried in any other part of the world and with many complicated problems of its own, into an underdeveloped country such as India.

Secondly, the expenditure tax grants a favorable treatment to all savings irrespective of the form in which the savings are held. It might be true that in an advanced country like Britain a large part of savings would flow automatically into productive investment. But, as we have seen earlier, in a country such as India relatively unproductive investment claims a substantial share of total savings. What is needed under these conditions is a scheme that would reward investment in particular directions.

Thirdly, the tax both as recommended by Kaldor and as introduced by the Government will affect only a relatively few individuals. Under the present provisions, only persons with a pre-tax income of Rs 60,000 will be liable to pay the expenditure tax. As indicated earlier, the number of assesseees

for 1958-59 is estimated to be 6000. Kaldor's recommendation was that the tax should be levied on personal expenditure in excess of Rs 10,000 per adult (an infant counting as $\frac{1}{2}$ adult). If we assume four adults per family, a person would become liable to the expenditure tax under the Kaldor scheme only if his family expenditure was above Rs 40,000. This would mean that under Kaldor's proposals only persons with pre-income-tax incomes considerably above Rs 40,000 could have been expected to become liable to the expenditure tax. Therefore, Kaldor's tax would have affected about the same number of individuals as the tax now introduced. If it is our aim to encourage savings in the economy, is it sufficient to introduce a tax that cannot affect the economic behavior of any but a small number of individuals?

The income tax revenue statistics for 1956-57 throw some light on the distribution by income-groups of income tax payers and of assessed income.¹ Out of a total of 499,621 individual assessees, those with incomes not above Rs 55,000 were 492,393 or 98.55 per cent of the total; those with incomes not above Rs 25,000 were 466,741 or 93.42 per cent of the total. The total assessed income of individuals was Rs 5.52 billion. Of this, individuals with incomes not above Rs 55,000 accounted for Rs 4.69 billion or 84.90 per cent of the total; those with incomes not above Rs 25,000 accounted for Rs 379.22 billion or 68.72 of the total.

¹See Reserve Bank of India Bulletin, April 1958, p. 402, Statement VIII; original source, Income Tax Revenue Statistics--All India Statements, No. 6.

The expenditure tax affects individuals with income above Rs 60,000. This means that it fails to influence the behavior of more than 98.55 per cent of the taxpayers, who account for more than 84.90 per cent of the assessed income. For this reason we consider it a relatively ineffective weapon from the point of view of curbing unnecessary consumption in the economy as a whole. For this purpose the Government still relies on the usual type of income tax, which, however, discourages savings as much as consumption, probably more. As mentioned earlier, Kaldor had recommended that along with the levy of the expenditure tax the maximum rate of income tax be brought down to 45 per cent, capital gains be included in taxable income, and an annual tax on wealth be levied. He could claim that the lowering of the maximum rate of income tax would have a beneficial effect on saving and risk-bearing. The Government of India, however, decided not to include capital gains in taxable income nor to lower substantially the maximum marginal rate of super tax. The Government, therefore, cannot claim that it has done much to encourage savings except in regard to those few who are affected by the expenditure tax.

It was pointed out earlier that one of Kaldor's objections to the usual type of income tax is that it is not based on a true measure of the spending power of the individual. It is obvious that the same sort of criticism can be laid against the expenditure tax. It is based not on spending power possessed, but on spending power actually exercised. Kaldor anticipates this criticism and argues that if the tax

is progressive, the relationship between spending and spending power can itself be taken into account in determining the rate of progression of the tax.¹ Even if this were done, however, as between two individuals with the same incomes who did not spend the same proportion of their incomes the tax levied would not be in proportion to their respective spending powers. Moreover, in order to take this relationship into account it would be necessary to get an idea of total income in each case. This would raise all the problems of measuring true spending power to avoid which the expenditure tax was advocated in the first place. Therefore, Kaldor is forced to shift his ground. He asks: "But is it so evident that it is preferable on moral grounds to tax people on the basis of their ability to spend rather than on their actual spending?"² And he is inclined to argue that it is not, on the ground that "it is only ^{by} spending, not by earning or saving, that an individual imposes a burden on the rest of the community in attaining his own ends."³ This argument is tantamount to abandoning the principle of taxing according to "means" or "ability," for the violation of which he has elsewhere criticised the present system of income taxation.

It is to be noted also that so long as we do not completely replace the income tax by the expenditure tax, all the problems of converting accruals from various sources into common units of spending power or taxable capacity will

¹An Expenditure Tax, p. 49.

²Ibid., p. 53.

³Ibid.

remain with us. The only merit that a partial replacement of the income tax by the expenditure tax can claim is that it is more conducive to saving than a comprehensive income tax.

Kaldor puts forward one further argument in favor of the expenditure tax. He argues that if income and property are taxed too severely, while expenditure out of accumulated wealth is not taxed or restricted, the effect will merely be to encourage the capitalists to dissipate their wealth rather than to reduce their living standards.¹ He holds that the wealthy classes in Britain have ceased to save and that they dis-save on a considerable scale--at least in relation to their taxed incomes.² As Lakdawala points out, this is an exaggerated view of the behavior of the rich.³ It is not clear that a progressive income tax of the usual type actually induces the average capitalist to dis-save to any significant extent. It is heavy inheritance taxation that is often held to cause the squandering of wealth in expectation of the tax. Kaldor, however, maintains that the incidence of the inheritance and gift taxes is entirely on the inheritors and donees.⁴ It is not open to him then to argue that heavy inheritance taxation would induce the dissipation of wealth. Why should the expectation of a tax whose incidence is on the inheritors affect the behavior of

¹Kaldor Report, p. 40.

²In Expenditure Tax, p. 93.

³D. T. Lakdawala, op cit. p. 160. Lakdawala refers to two surveys carried out recently in England which tend to throw doubt on Kaldor's contention that the rich dis-save on a considerable scale.

⁴Kaldor Report, p. 49.

the testators?

It is on all these grounds that we reject the idea of a separate expenditure tax to be super-imposed on the basic income tax. It is submitted that, especially under conditions prevalent in India, it would be much better to build a scheme of partial exemption for savings within the structure of the income tax, which should include in its scope all realized capital gains.

c. Evaluation of the Annual Tax on Wealth. The annual tax on net wealth is not an innovation like the expenditure tax. Analogous taxes are being levied in some European countries like Sweden, Denmark, and Switzerland. Kaldor justifies the imposition of this tax on the three grounds of equity, economic effects, and administrative convenience. The Government of India has given the need to reduce inequalities as an addition justification.¹

Let us take the equity argument first. To quote Kaldor: "The main argument in equity for the tax is that income taken by itself is an inadequate yardstick of taxable capacity as between incomes from work and incomes from property, and also as between different property owners. The basic reason for this is that the ownership of property in the form of disposable assets endows the property owner with a taxable capacity as such, quite apart from the money income which that property yields."² It will be recalled that

¹Reserve Bank of India Bulletin, June 1957, p. 536.
²Kaldor Report, p. 20.

this is one of the arguments Kaldor uses in his criticism of the income tax. Most economists are agreed that income by itself is not a full measure of taxable capacity. This is one of the arguments that is usually adduced in support of death duties. Since the estate duty is one form of wealth taxation, if it is levied at fairly high rates, it tends to redress the balance between property owners and others and makes for a more equitable system of direct taxation. It may be true that the main justification for inheritance taxation is the need to prevent the perpetuation and enhancement of inequalities. But that does not prevent a death duty, once it is levied, from fulfilling other functions as well. The effects of a measure are the same, whatever our motives in introducing it. Therefore, it is extremely doubtful whether there is any case for introducing an additional tax on wealth on the above-mentioned ground alone.

From the economic point of view, the annual tax on wealth has been justified on the ground that a tax on capital value does not discriminate against the risky employment of capital in the same way as an income tax. There is truth in this argument. In order to reap this advantage, however, it would be necessary to lower the rates of income tax concurrently with the imposition of the wealth tax. Kaldor did recommend to the Government that the maximum rate of income tax be reduced to 45 per cent (plus surcharge). Presumably on revenue grounds, the Government found itself unable to make such a drastic reduction. However, it did reduce the rates of income tax somewhat and brought down the highest

marginal rate from 91.9 per cent to 84 per cent (inclusive of surcharge). This slight lowering of the rates is not likely to alter significantly the presumed adverse effect of the income tax on the incentive to work and bear risks. Actually, the higher income groups are now asked to pay more in direct taxation than before the imposition of the wealth tax.¹ More than this, those with unearned incomes between Rs 40,000 and Rs 150,000 pay more in income tax alone now than in 1956-57. Of course, they are in addition subject to the wealth tax. In the light of these facts, it would be too much for the Government to claim that recent changes in taxation have reduced in any way the deleterious effects of direct taxation.

The annual wealth tax is made applicable to companies also. None of the arguments given in support of the tax warrant the extension of the tax to corporations. It is true that some of the European countries levy this tax on companies also. Of the six countries which do, Sweden and Denmark exempt all domestic companies.² An underdeveloped country like India cannot blindly follow the example of de-

¹For example, a married man with an unearned income of Rs 200,000 would have paid Rs 144,504 in income tax under 1956-57 rates; now he pays Rs 142,752; there is a difference of Rs 1852. If we assume a net return of 5 per cent on capital owned, his wealth will amount to Rs 4,000,000 and he will have to pay Rs 42,000 in wealth tax; if we assume a net return of 10 per cent, his wealth will amount to Rs 2,000,000 and he will have to pay Rs 13,000 in wealth tax.

²The Eastern Economist, Budget Number, March 7, 1958, p. 533.

veloped countries. The taxation of the "wealth" of the companies raises Indian company taxation to levels reached in economically advanced countries. Indeed above the income level of Rs 500,000, Indian taxation is higher than in the United States and the United Kingdom.¹

It is not intended to argue here that the wealth tax should be abolished. The enactment of this measure of taxation is now considered in India as a great victory for the common people in their progress toward equality. Politically, it will be all but impossible to withdraw this measure. Nor do we think that it is absolutely essential that the wealth tax should be abolished. As has been argued earlier, the wealth tax can be used to check the unlimited growth of inequalities. In our view, the wealth tax is a suitable measure for preventing the accumulation of individual wealth beyond a socially defined level. This is the only objective that should be expected of the wealth tax. On this basis the following modifications are suggested: (a) the exemption level should be raised to a higher figure, say, Rs 500,000; (b) companies should be made exempt from the wealth tax; (c) if it is desired to differentiate further between property incomes and work incomes, a higher earned income relief may be granted; and (d) the gift tax and the estate duty may be retained in their present form for the time being.

d. Concluding Remarks on Reforms Initiated by Kaldor.

One of the important arguments put forward by Kaldor in support

¹Ibid., p. 527.

of his proposals is that this system is much more evasion-proof than the system he found in India and elsewhere. He argues that since property income and property value are related, if taxes are assessed on both income and property, the administrative efficiency of the system is bound to be improved. If taxes are levied on wealth, income, and expenditure, the assessee has to file comprehensive tax returns. This requirement provides for self-checking in two ways: (a) an assessee has to be consistent in his returns; (b) the attempts of one taxpayer to minimize his liability will immediately increase the liability of another. It may be pointed out, however, that if income is concealed and hoarded, it can be kept out of the tax return with the utmost consistency. Since regular house to house search is not contemplated by the Government, concealed income can be hoarded in the form of gold and cash. Moreover, if there are merits in a comprehensive tax return, it can be required of the income tax assessee. The merits of a certain type of return may be a sufficient argument for the introduction of the return itself, not for all the taxes that can be levied on the basis of the return. We must remember also that the complexities of administering the tax system are considerably increased by the introduction of the wealth and expenditure taxes. There are the problems of determining the personal expenditures of the taxpayers, of keeping track of all property transactions, and, above all, of determining the value of all taxable property. It is an open question whether, on balance, the efficiency of the system as a whole will be

improved.

Kaldor's proposals provide for the taxation of capital gains, wealth, expenditure, and gifts. It is somewhat surprising to find Kaldor advocating a wealth tax in addition to taxation of capital gains, after all his **inveighing** against "the double taxation" of savings. Under his system an individual is taxed whether he spends or saves. An expenditure tax taken by itself tends to encourage savings; a tax on wealth tends to discourage accumulation and encourage spending. Kaldor argues: "A combination of the two types of taxes, therefore, far from cancelling the good effects of either, make it possible to restrict effectively the living standards of the rich without sacrificing the long-run egalitarian objective of a more even distribution of property."¹ The net effect of such a combination of taxes cannot be stated so categorically without reference to the relative heaviness of the two types of taxes. If the rates of wealth taxation were high enough to reduce inequalities, a wealth tax would certainly counteract the effects of the expenditure tax. If the rates are not high enough, there is no case for introducing so complicated a device.

Kaldor had estimated that his proposals, if accepted, would have raised tax revenues by more than Rs 600 million per year. The changes effected in the tax system since the submission of Kaldor Report are expected to bring in extra revenue to the extent of Rs 200 million per annum. It must

¹Kaldor Report, p. 40.

be pointed out that this extra taxation is levied on the same minority of less than one million persons who bear the brunt of direct taxation. It is not suggested that the rich in India should not be asked to pay more taxes. But it is important to bring under charge the "feudal" incomes that now almost certainly escape taxation before we ask this minority of business and professional classes, who are already paying taxes, to pay more. Rapid economic development is impossible unless the surplus from agriculture is channelled into investment. During the initial stages of her economic development Japan followed the exactly opposite policy of heavy taxation of agriculture and light taxation of industry. In India, according to Mr. S. J. Patel's calculations, out of Rs 21.7 billion received as gross property income in 1950-51, over Rs 14.0 billion, or a little less than two-thirds, is obtained as rent of land and interest on cultivator's borrowing; only one-third of the income from property is derived from modern industrial and commercial enterprises.¹ It is the latter that bears the brunt of direct taxation. This is seen from Table XIV. We find that "gross profits" of Rs 7.5 billion bore a tax burden of Rs 1.72 billion, whereas "feudal" incomes amounting to Rs 14.2 billion bore a burden of Rs 260 million only. Mr. Patel seems to have omitted to include agricultural income tax paid, which is now around Rs 57 million. Even when this is added, the total direct tax paid by the recipients of "agricultural" incomes comes only to

¹S. J. Patel, op. cit., p. 10.

Rs 317 million. As indicated in the section on Income Tax, the most important reform to be carried out in the Indian tax system is to devise means by which "feudal" incomes could be brought under charge. Recent tax reforms have not touched this vital problem except in so far as the wealth tax may lead to the disclosure of some evaders.

Table XIV
DISTRIBUTION OF DISPOSABLE INCOME AFTER TAXATION
(1950-51)

	Rs Millions		
	Total Income	Direct Taxes	Disposable Income
1. Wages and Salaries	21,800	70	21,730
2. Income of the Self-Employed	49,730	260	49,440
3. Income from Property	21,700	1,980	19,720
Of Which:			
Rent from Land	7,700	260	7,440
Interest on Cultivator's Debt	6,500	-----	6,500
Gross Profits ^a	7,500	1,720	5,780

Source: S. J. Patel, op. cit., p. 12.

^aTotal of gross profits in mining, manufacturing, private commerce and transport, rent from urban housing, and miscellaneous.

Note: The figures given by Mr. Patel are only approximations.

D. Indirect Taxation

The important indirect taxes levied in India are customs, excise and sales taxes. It will be recalled that the Constitution reserves to the Union Government the power to levy customs duties and excises on all commodities except alcoholic liquor; and that it reserves to the States the power to levy excise on alcoholic liquor and sales taxes on all goods except newspapers and advertisements therein. Customs, Union excise duties, and State sales taxes together constitute the basic structure of indirect taxation in India. Only the Union excises and State sales taxes will be considered here.

1. Union Excise Duties

Until recently, customs constituted the largest single source of revenue to the Union Government. Now its place has been taken up by excise duties. In the budget estimates for 1957-58, about 40 per cent of the tax revenue of the Union Government was derived from excise.¹ In the budget estimates for 1958-59, excise duties are estimated to bring about Rs 3.05 billion, while customs are estimated to bring only Rs 1.7 billion.² Customs have steadily lost their relative importance, though in absolute terms still an important source of revenue, because of a policy of protection, the growth of consumer goods industries, import and exchange control, and fairly light taxation of capital goods which

¹Reserve Bank of India Bulletin, April 1957, p. 330.

²Reserve Bank of India Bulletin, March 1958, p. 239.

are being imported in increasing quantities. The Central Government has been resorting to excises to recoup the revenue lost through the relative fall in customs revenue.

Central excises were not very important until the 'thirties. The first excise duty was levied on cotton yarn in 1894. This was later changed into an excise on mill-made cloth and was abolished in 1926. Of the present excises, the earliest was the levy on motor spirit (gasoline) in 1917. The duty on kerosene was introduced in 1922 and that on silver in 1930. The year 1934 is a landmark in the development of Central excises, since it was in that year that duties were imposed on sugar, matches, and steel ingots. The industries producing these goods had grown up under protection and they were taxed to replace the revenue lost from customs.

The years of World War II witnessed the further extension of excise duties. The government explored various ways of increasing revenue and began to increase steadily the coverage of excise taxation. During these years duties were imposed on tires, vegetable products, tobacco, coffee, tea, and betel nuts.

It was realized that excises were a rich source of revenue and the Government of India did not hesitate to exploit this source after the end of the war. In 1949 the excise duty on mill-made cloth was re-introduced; in 1954 duties were imposed on art silk, cement, soap, and footwear. Reporting in early 1955, the TEC recommended the levy of excises on a number of commodities untaxed until then. It

recommended also substantial rate increases in the duties on kerosene, sugar, and matches, and moderate increases in the rates of duty on cloth and tea.¹ The Government of India was quick to act on the recommendations of the TEC. In 1955-56 and 1956-57, some existing duties were raised, notably that on cloth, and new duties were imposed on electric bulbs and fans, paints, varnishes, paper, woollen cloth, electric dry and storage batteries, vegetable non-essential oils, and all kinds of diesel, vaporizing and furnace oils. The government expected to increase revenue by about Rs 338 million as a result of these measures.

Increased excise taxation was not to be halted at this point. In the 1957-58 budget, the bulk of the additional taxation proposed was by way of indirect taxes. The then Finance Minister proposed to raise the level of duties on a host of items, including sugar, tea, coffee, tobacco, matches, oils, kerosene, motor spirit, and cement. The net result of his proposals was a substantial increase in revenue of the order of Rs 573.5 million.²

Thus excise taxation has grown by leaps and bounds in the last 25 or 30 years. In the middle 'thirties, excise duties covered only five commodities, but now the list of articles covered is fairly long. The bulk of the revenue, however, is derived from the following commodities: cotton cloth, tobacco, sugar, matches, and tea. Of these, cotton

¹TEC Report, Vol. II, pp. 365-367.

²Reserve Bank of India Bulletin, June 1957, p. 534.

cloth is the largest single source of revenue.

During these years of development of excise taxation at the Center, the States were independently developing and exploiting another prolific source of revenue, namely sales taxation. Until recently there has been no co-ordination between excise taxation and sales taxation. In 1957, however, the States agreed to exempt from sales taxation textiles, sugar, and tobacco, and the Union Government levied additional excise duties on these commodities, the proceeds of which were to be distributed to the States.

One particular feature of Central commodity taxation is that both customs and excise duties are mostly specific. However, generally speaking, higher rates of duty are imposed on luxuries and superior varieties of products than on widely consumed goods and inferior varieties. Another feature is that the Union excise covers many goods which may be classed as necessities, such as cloth, kerosene, and sugar. Since the sales taxes of the States are in the nature of "general" taxes, the same necessities are liable to be taxed at the Union as well as the States level, unless necessities are exempted from sales taxes.

2. State Sales Taxes

Before 1938 there was no sales tax in India. Now all the States impose a sales tax of one kind or another. Sales taxation has become a very important source of revenue for the States. In 1956-57, it brought Rs 706.6 million out of a total tax revenue of Rs 3.67 billion. As noted earlier, it is coming to occupy the first place in State finances,

apart from the contributions of the Union Government and shares of Central revenues.

There are many kinds of "sales taxes" in operation in the several States of India. First of all, we may distinguish between a sales tax proper and a purchase tax. When the tax is assessed on the turnover of the sales of a registered dealer and collected from that dealer, it is called a sales tax. If, on the other hand, it is assessed on the turnover of his purchases, irrespective of whether he has sold what he has purchased, it is called a purchase tax. The sales tax is levied only on dealers, including in that term manufacturers, processors, traders, etc. The purchase tax can be levied on the consumers also, especially where the article bought is conspicuous and more or less readily traceable. Usually the sales tax is preferred to the purchase tax, the latter being resorted to in special cases for specific administrative reasons.¹

Another broad distinction made in India is between the "general sales tax" and the "selective sales tax." If the tax is collected on the generality of goods passing through the hands of a dealer, and hence on what may be called his turnover, it is called a general sales tax. If, on the other hand, only certain selected goods are brought under the purview of the tax, it is called a selective sales tax. The general sales tax, wherever it is levied, is not

¹For example, it has been found to be more convenient to tax the purchases of a dealer in peanuts who buys from numerous farmers inside his State and sells to manufacturers outside his State.

a truly general tax: services are excluded from taxation in all States and at least a few commodities are exempt in each State. Most of the State sales taxes are in the nature of general sales taxes.

There are two main varieties of the general sales tax: the multi-point system and the single-point system. Under the multi-point system the tax is levied on the series of successive transactions that take place when the good passes from the producer to the final consumer. Under the single-point system, the tax is levied at only one stage. Thus a retail sales tax would be a single-point general sales tax. "An important distinction, in conception and design, between the multi-point system and the single-point system is that the latter seeks to ensure as far as possible that not more than a specific amount of tax gets added to the price at which the article is sold to the consumer; in other words, that the total tax charged in the passage of the article from the first dealer to the last in what may be a whole chain of dealers is not left to be decided by the indeterminate number of links which may exist in the chain, but is collected at only one of the number of sales which may be involved."¹ Under the multi-point system the rate is relatively low and the exemptions are few; under the single-point system, on the contrary, the rate is relatively high and the exemptions are larger in number. Under the former system the accounts which the dealer has to keep are less complex than under the latter

¹TEC Report, Vol. III, pp. 5-6.

system. This follows from the fact that under the single-point system we have to make sure at every stage that the tax was not paid at a previous stage and is not going to be paid at a later stage.

Bombay has a double-point system under which the tax is levied at two stages in the series of transactions. This is a sort of compromise between the single-point and the multi-point systems.

Not all dealers in a State are liable to pay the sales tax. The law in each State lays down the minimum value of turnover which will make a dealer liable to payment of the tax. Different limits of turnover are laid down in different States to fix this liability. Usually there are two distinct exemption levels, one for importers and manufacturers and the other for all other dealers. A relatively low limit or exemption level has been found necessary in the case of importers and manufacturers.¹ All dealers liable to pay the tax are required to be registered with the State government concerned. The exemption level for importers and manufacturers is nowhere more than Rs 10,000. It is as low as Rs 5,000 in Madhya Pradesh. The exemption level for other categories of dealers varies considerably from State to State. In 1954, it was Rs 7500 in Assam; Rs 10,000 in Madras, Mysore, Orissa, and Kerala; Rs. 15,000 in Uttar Pradesh and Bihar; Rs 25,000 in Bombay and Madhya Pradesh; and Rs 50,000 in Bengal and Punjab.²

¹For reasons see TEC Report, Vol. III, p. 11.

²Ibid.

In addition to sales by dealers with a turnover less than the exemption level, certain other sales such as sales not in the course of trade or business, sales of immovable property, sales of stocks and securities, and sales of agricultural produce grown by the cultivator himself or on land owned by him also are exempt from taxation.

Besides the above-mentioned, there are certain specific exemptions. These may be divided into four categories: (a) goods which are treated as "essential" or as necessities; (b) goods which are taxed under separate enactments; (c) products of certain cottage and village industries; and (d) certain other articles like text-books, fertilizers, and cattle food. The list of exemptions varies from State to State. As already pointed out, it is larger under the single-point systems than under the multi-point systems. Madras has the shortest list, the only articles exempted being salt, handloom yarn, and khaddar.¹ Article 286 of the Constitution prohibits the States from levying taxes on goods declared by Parliament to be "essential" for the life of the community, except with the previous assent of the President. This provision, however, is made applicable only to State laws which did not exist before the coming into force of the Constitution.

The sales tax law of each State specifies a standard rate generally applicable to taxable sales. However, on some articles lower or concessional duties are charged, where-

¹Khaddar is cloth woven on handlooms with handspun yarn.

as on others, which are in the nature of luxuries, higher rates are charged. For example, the Madras general sales tax is levied at the general rate of about 1.5 per cent. But, by way of exception to this multi-point levy, cotton yarn is taxed at only one stage of sale at one-half per cent; bullion and specie at one stage at one-quarter per cent; and hides, skins, and cotton at one stage at the ordinary rate. On the other hand, certain luxury articles like automobiles, radio sets, electrical goods, and cameras are subject to an additional tax of 1.5 or 3 per cent at one stage. The pattern of rates is more or less the same in all the States.

The foregoing description of sales taxation in India points up the fact that the sales tax has developed into a distinct and useful form of taxation. Theoretically, and from the point of view of incidence, there is not much difference between a sales tax and an excise to the extent that they fall on the same commodities. But there are other characteristics which distinguish them. In the words of the TEC,

Excise duties are collected from the manufacturer on his production even if there are no sales, whereas the sales tax is collected only when the manufactured goods are sold. Further, excise duties usually have proximity to the points of production. Moreover, for very good reasons, excise duties are necessarily selective, and therefore the rates of duty are normally high, whereas the sales tax operates at different points of the trade channel, over a larger number of commodities and in varying degrees of proximity to the final consumption and can therefore be levied at comparatively low rates. It follows that the sales tax can be varied in relation to the different grades of consumers in a manner which is not generally open to excise. In other words, the sales tax can take cognizance of the varying degrees of specialization and differentiation which occur

in goods as they leave the stages of production and primary processing with which excise is concerned.¹

In view of these distinguishing features of the general sales tax, it can be made to play a role somewhat different from that assigned to excise duties.

3. An Examination of Excise and Sales Taxation in India

In our discussion of indirect taxation contained in Part III, it was suggested that the structure of indirect taxation must be so fashioned as to achieve certain important objectives. These are: to raise revenue, especially from those who cannot be reached through direct taxes; to curtail the consumption of luxuries; and to restrain a rapid increase in mass consumption of non-necessaries. In order to achieve these objectives, it would be helpful to have in the tax system both excises and sales taxes. As mentioned above, "the sales tax can take cognizance of the varying degrees of specialization and differentiation which occur in goods as they leave the stages of production and primary processing." Further, under a federal structure, the introduction of sales taxation becomes necessary as a substantial source of revenue for the State governments. The production and manufacture of commodities considered suitable for excise taxation may be concentrated in a few States. It will then be best to leave excise taxation to the Central government. Central excise taxation will insure uniformity of taxation on the production of manufacture of a particular commodity through-

¹TEC Report, Vol. III, pp. 43-44.

out the Union. It is then left to the States concerned to determine the burden of taxation to be borne by the consumers living within their respective borders.

The general sales tax is a suitable device for restraining increases in general consumption. It can help the government to increase the incremental saving ratio, because it makes the tax system more income-elastic. The tax system of an underdeveloped country, therefore, should contain the general sales tax. The type of tax needed is a multi-point system which would cover all consumer goods except necessities. The tax should be levied at a flat rate applicable to all taxable sales, but luxury items should be subject to an additional tax at one stage in the series of transactions. Capital goods must be exempt from the purview of sales taxation. The general sales taxes in India satisfy the requirement of generality and of differential rates. But not all the States exempt necessities like food grains and cheap cloth. Indeed, in Madras the items which yield the largest revenue are paddy and rice, articles sold in provision stores, and mill cloth.¹ In defense of its policy, the Madras government has pointed out that the rural consumers do not have to pay the tax on food grains because the cultivator consumes for the most part what he grows in his own field. If the rural consumers "escape" the tax on many necessities, there is no reason why the poorer sections in urban areas alone should be subject to the tax. As we have argued earlier, there is no case for

¹Ibid., p. 36.

taxing necessities in a poor country like India. The TEC was of the opinion that the small dealers in semi-urban and rural areas would be unable to maintain complicated and separate accounts. Therefore it suggested that there should be few exemptions or none at all from the multi-point levy.¹ But in another connection the TEC itself recommended that for dealers who could not maintain elementary accounts, "there should be a scheme of composition under which the liability to tax is assessed on the basis of the purchases made."² Even now some States have this scheme. Since the inability of the small dealers to keep accounts can be got around in this manner, this reason for not providing for exemptions is not of much importance. Besides, under a recent agreement (December 1957) between the Union and State governments, the Union government is levying additional excise duties on sugar, textiles and tobacco in lieu of the sales taxes. This means that these items have to be exempted from the general sales tax of all the States. If exemptions are going to be introduced at all, separate accounts must be kept of exempt and non-exempt items and the addition of a few more exemptions will not make much difference.

The TEC suggested that the single-point levy on "luxury" items must be at the retail stage and the exemption level of turnover must be much higher than for the multi-point levy. This would insure that only dealers with a

¹Ibid, p. 63

²Ibid., p. 64.

fairly large turnover capable of maintaining fairly complicated accounts would be subject to the tax. We agree with this suggestion.

b. Union Excise Duties. The levy of excise duties, in addition to the sales taxes, is necessary, first of all, to insure sufficient revenue for the Union government. Under the Indian Constitution, the yield from taxes on personal income is divided between the Union and the State governments and the entire net proceeds from the estate duty are assigned to the States. It is therefore necessary that taxes on commodities also be shared between the Union and the States. Besides, whereas the general sales tax is a useful device for checking increases in general consumption, particular excises are more suitable for causing inter-industry diversions of resources. It is considered, therefore, that the existing arrangement, under which the Union levies excises and the States levy sales taxes, is essentially satisfactory.

It is inevitable that with the decline of customs the relative importance of excises in the scheme of Union finances should increase. While it is legitimate for the government to increase its revenue from excises, it is important that the commodities to be taxed be selected in accordance with some definite principles. It is preferable, in general, to confine excises to commodities that satisfy one or more of the following characteristics: (a) low price-elasticity of demand; (b) high income-elasticity of demand; (c) absorbing scarce factors needed in the public sector; and (d) in the nature of luxuries consumed only by the well-

to-do. The bulk of the excise revenue must be derived from a few widely-consumed "mass luxuries," which are likely to satisfy the first two characteristics. Good examples are tea, coffee, tobacco, and superior varieties of cloth. Taxation of these goods insures that sufficient revenue can be expected to be raised, because of low price-elasticity and high income-elasticity. Outside of the types of goods mentioned above, certain selected commodities can be taxed with the diversionary effect in view. Luxuries and scarce "bottle-neck" factors needed in the public sector are examples of this type of commodities.

As we have indicated earlier, there is no case for taxing necessities. Nor is there a case for indefinitely extending the scope of excises. While it is true that the bulk of the excise revenue is derived from the taxation of certain non-necessaries like tea, tobacco, and superior varieties of cloth, the Union Government taxes also certain necessities like cheap cloth and sugar. Even if it is maintained that refined sugar is in the nature of a "luxury" because the poor use mostly unrefined sugar or gur and that therefore refined sugar can be justifiably taxed, there is no case for the taxation of cheap cloth. Nor is it justifiable to tax kerosene at the high rates prevailing now.

Equally questionable is the policy of steadily extending excises to cover all industries that have grown up under protection. The TEC, unfortunately we think, lent its sanction to this policy. It noted: "The principles underlying the extension of excises from time to time are

that indigenous industries which have developed under a protective tariff wall should be called upon to replace the loss of customs revenue on imports and that the country's tax structure can be made stable only by broadbasing the excises."¹ And when it looked around for new industries to be taxed, it mentioned the paper industry, among others, and said: "The industry has developed as a result of tariff protection, and this provides justification for the levy of an excise duty on paper."² The same argument was used in the case of some other goods selected for new taxation.³

While it is true that excises as a whole have to replace to some extent the loss in customs revenue, why should the grant of protection be considered a sufficient justification for taxation? Protection is (or should be) granted in the national interest. It is intended that the protected industries should grow. It could hardly be maintained, moreover, that the consumers of protected **products** have benefited directly from the policy of protection. On the contrary, they have been forced to pay higher prices because of protection. And they continue to pay the higher prices as long as the domestic price is higher than the price of the imported product exclusive of the import duty. It is far from reasonable then to ask these same consumers to bear the extra burden of the excise duty except perhaps in those cases where the domestic cost of production has been brought down so low

¹TEC Report, Vol. II, pp. 257-258.

²Ibid., p. 315.

³Ibid., pp. 315-317.

as to have made possible the removal of the protective tariff. Indeed it could be argued with greater validity that while the consumers of the protected industries are bearing the brunt of protection, the consumers of the non-protected industries should be required to bear the burden of excises. Actually, however, protection and non-protection cannot be important considerations in selecting commodities for excise taxation. It is submitted that the principles we have put forward earlier must be applied in every case before taxation is decided upon.

One reason why the Union Government has been forced to extend the coverage of excise taxation is that the revenue from excises has been very inelastic with respect to price and money income changes. This is due to the fact that excise duties are mostly specific. While prices have been rising almost steadily since 1938, the revenue from excises existing at any given time has lagged behind, so that the Government has been forced to increase the rates of existing taxes and add continually to the list of goods taxed. For example, in the case of articles subject to duty between 1938-39 and 1953-54, it was found that, in spite of rate increases, the rates of duty as percentages of the prices of the articles taxed declined substantially during these years, with a consequent reduction in the average tax burden on these articles. The extension of coverage was more significant than the rate increases in bringing more revenue. "Thus, in 1953-54, only 29 per cent of the revenue from excise duties was raised from articles which were subject to duty also in

1938-39 and 76 per cent from articles which were taxed in 1948-49."¹

It is suggested that it might be a better policy to convert as many of the duties as possible into ad valorem duties than to extend the excise to such goods as dry and storage batteries, tires, and varnishes. Apart from other reasons, the continual extension of coverage makes the whole excise administration complex and unwieldy.

In closing, we may mention two other cases in which excise duties can be used. The first is the case of petrol, which is taxed in all countries on the basis of "benefit principle." The second is the case of goods whose exports can be promoted to earn more foreign exchange by discouraging domestic consumption. This policy is fruitful, however, only when the elasticity of the foreign demand for the product concerned is greater than unity, for if it were less than unity, the fall in the price due to increased exports would lead to a shrinkage in the foreign exchange earned. In India it may be possible to promote the export of superior varieties of cloth by such a policy.

E. Deficit Financing in the Second Five-Year Plan

One of the important features of the Second Five-Year Plan of India is the important place accorded in it to deficit financing. In an attempt to raise the rate of investment in

¹TFC Report, Vol. II, p. 259.

the economy, the Planning Commission has thought fit to provide for a large dose of deficit financing in the five-year period covered by the Plan (1953-61). Before we proceed to consider the case for a policy of deficit financing in planned economic development, it is necessary to define the term "deficit financing" as it is used in India.

1. The Definition of Deficit Financing

In the United States, the term "deficit spending" or "deficit financing" is generally used to mean any expenditure by the government that is in excess of its current revenues. Hence expenditure that is financed by borrowing from the public is included in the measure of deficit in the budget. In India, however, expenditure financed by borrowing from the public is excluded from the measurement of deficit. Thus only expenditure in excess of current revenues and non-bank borrowings is termed deficit spending. This concept of deficit may be called the economic concept of deficit. According to this concept, the term deficit is applied to expenditure financed only by those means which have a tendency to increase the total outlay in the community.

If a deficit is defined this way, expenditure financed by borrowing from the public can be excluded from the deficit only on the assumption that such expenditure, because it is financed out of genuine savings, has no tendency to increase total outlay. This assumption is implicit in the Indian usage of the term deficit financing. Strictly speaking, this assumption is not completely valid. Moreover, it is extremely difficult to record government borrowing according

to the type of lender. In the words of the Planning Commission, "While the monetary impact of government's borrowing will differ according to type of subscriber, it would clearly be impracticable to record government's borrowing operations on this basis. Nor does the ownership of public debt remain with the same person or institution that bought it to begin with."¹ Therefore, this definition of deficit is only "a convenient convention which under prevailing practices gives as near an approximation to the purpose in hand as possible."²

A deficit so defined can be financed in one or more of the following ways: (a) borrowing from the Central bank; (b) withdrawal of cash balances; (c) borrowing from the commercial banks; and (d) issue of new currency by the government. In India, however, the last means is not usually employed. Further, in governmental accounting practice, borrowing from the public and from the banks are lumped together as "market borrowings." Hence the figures for annual deficits given by the Government or the Reserve Bank of India include only withdrawals of cash balances and net borrowing from the Reserve Bank.

2. Deficit Financing and Economic Development

The use of deficit financing as a method of accelerating the pace of economic development and the dangers inherent in such a policy have been discussed by many economists in

¹Second Five-Year Plan, p. 84.

²Ibid.

recent years.¹ The consensus among them is that a moderate² amount of deficit financing can be indulged in during the process of economic development and with appropriate safeguards, but that it should ne er be such as to lead to inflation in the economy. Once inflation develops in the economy, it may be difficult to control it, especially in underdeveloped countries. What looks like a mild inflation may develop easily into hyper-inflation. A continuing state of inflation is neither a healthy way of promoting development nor, in the last resort, conducive to development itself. Hence if deficit financing is employed in such a way as to generate inflation, it defeats its own objectives.

It may be argued that inflation has a tendency to promote investment by increasing the profitability of investment and the incomes of profit receivers who are likely to invest their additional incomes. This is true to some extent, especially in the earlier stages of inflation. It must be remembered, however, that profit earners will save only a part of the

¹See, among others, E. M. Bernstein and I. G. Patel, "Inflation in Relation to Economic Development," I. M. F. Staff Papers, Vol. II, No. 3, November 1952; V. K. R. V. Rao, Deficit Financing Capital Formation and Price Behaviour in an Under-Developed Economy, Eastern Economist Pamphlet, New Delhi, 1953; "Deficit Financing for Economic Development," Economic Bulletin for Asia and Far East, Vol. V, No. 3, November 1954; Gustav F. Papanek, "Development Problems Relevant to Agricultural Tax Policy," in Agricultural Taxation and Economic Development; and Martin Bronbenbrenner, "The High Cost of Economic Development," Land Economics, Vol. XXIX, No. 3, August 1953.

²Moderate relatively to national income and total government expenditure.

additions to their incomes. On the other hand, fixed-income earners will find their real incomes reduced and may decrease their savings or actually dis-save. Therefore, a heavy shift in income to profit receivers will be necessary to effect a net increase in the total savings of the economy. Such large shifts of income to entrepreneurs at the expense of mostly wage and salary earners will accentuate the disparities of income and wealth in an uncontrolled and glaring fashion and may, therefore, lead to serious social unrest.

Further, inflation has been found to distort the pattern of production and investment. Businessmen are concerned with ownership benefits and not with use benefits. Inflation broadens the scope for profitable investment where use benefits are low and ownership benefits are high.¹ Three such fields of investment are inventory holding, luxury urban construction, and foreign assets. The tendency to speculation also is strengthened. Hence the type of investment promoted by inflation may be precisely those not needed in underdeveloped countries.

Eventually, inflation is self-defeating. After a stage, in the race between costs and prices, the economy gets into the grips of spiral inflation. If, on the contrary, prices are prevented from rising after costs have risen, the increased profitability of investment is eliminated and investment may fall to, or below, the pre-inflation level.

¹E. M. Bernstein and I. G. Patel, op. cit., p. 383. The authors' observations are based on the experience of many Latin American countries.

Only when the rise in prices is not followed by a proportionate rise in costs, will there be a permanent gain in investment from the inflationary method. This means that the original price rise must be moderate enough not to induce a concomitant rise in costs. In other words, the price rise due to deficit financing must not be inflationary. We may conclude in the words of Bernstein and Patel:

The overpowering strength of the forces let loose by inflation to achieve what in fact is likely to be only a moderate increase in investment (which could have been achieved, in large part if not entirely, by less aggressive means) ultimately converts continuous inflation into a destructive policy. A large part of any increase in investment will take forms that are of negligible importance in increasing agricultural and industrial production. The economy is distorted by the inflation so that its use of productive resources is less effective than it would otherwise be. And the effects of the inflation on the distribution of income and wealth are unhealthy and may be dangerous in countries with low incomes.¹

We may state categorically that inflationary deficit financing must be ruled out. However, while all deficit financing taken by itself is expansionary in its effects, it need not always result in inflation. The expansionary effects of deficit financing may be counter-balanced by the deflationary pressures operating in the economy in a given period. Or, concurrently with a moderate dose of deficit financing, appropriate policy measures may be taken to counteract, or hold in check, the expansionary results of the deficit so that though there may be a rise in prices, there may not

¹Bernstein and Patel, op. cit., p. 379.

result any inflation. In the first case there need be no rise in prices; in the second case there may be a rise in prices but no inflation.

We may consider first the possible forces that may counteract the expansionary effects of deficit financing in a developing economy. In a continuous process of economic development, investment is being continually undertaken. In every successive period, therefore, we may expect the total physical product to be higher than in the preceding period. The increases in physical product necessitate corresponding increases in the money supply for transaction purposes. Secondly, concurrently with development, the monetized sector of the economy tends to expand, giving rise to a further increase in the demand for money. Thirdly, as incomes rise, there is a tendency for the money/income ratio (the Marshallian k) to rise. This increasing demand for cash balances on the part of the public will tend to "absorb" some part of the money supply. Finally, if foreign aid is being extended to the country concerned, there may result an import surplus which also will exert a deflationary pressure. For all these reasons in an economy that is steadily growing, there will be an increase in the demand for money. If at this time the supply of money does not grow correspondingly, a deflationary situation will be created. An appropriate amount of deficit financing by the government can provide the increased money demanded and prevent a fall in prices. It follows that deficit financing can be safely employed only to this extent.

In this connection it must be remembered that part of the increased demand for money may be met by the creation of private bank credit that takes place independently of the government. The scope for non-inflationary government deficit financing is correspondingly limited.

If the amount of deficit financing, public and private, is in excess of what is warranted by the increase in the requirement for money in the economy, there will be a rise in prices. If such excess is not large, the government could try to prevent the rise in prices from becoming inflationary. Dr. V. K. A. V. Rao has argued that if part of the increased incomes is returned to the government in the form of taxes, the price rise need not be indefinite.¹ The greater the proportion of the increased national outlay that is returned to the government, the smaller is likely to be the final rise in price.² But Dr. Rao assumes that the rate of money wages can be made to remain unaltered. As he himself admits, this is the most important of all his assumptions.³ This assumption is valid only if there is "a small initial rise in prices as a whole and a smaller rise in the prices of basic necessities."⁴ We have argued earlier, in the section on indirect taxation, that in a country where a large section of the population is living on the margin of subsistence, it

¹V. K. A. V. Rao, Deficit Financing Capital Formation and Price Behaviour in an Under-Developed Economy, p. 20.

²Because of the "multiplier" effect of taxation working in the revenue.

³Ibid., p. 29.

⁴Ibid.

is difficult to prevent a rise in money wages when prices are rising. If inflationary tendencies are to be avoided, then the initial rise in prices must be very small indeed. If the price rise is to be moderate, argues Dr. Rao, there will be "need both for action to control the prices and allocation of essential raw materials and capital goods, and for action to control the money rate of wages, either keeping it stable or permitting only small changes in an upward direction."¹ It is questionable whether, in order to have a slight rise in the rate of investment, it is worth while introducing such comprehensive physical controls in the economy. Further, if inflation is to be ruled out as a measure of policy, this type of deficit financing cannot be practiced on an increasing scale.

The general conclusion that emerges from this discussion of deficit financing is that there is a place for it in an economy that is growing, but that it is not likely to be quantitatively significant as a means of raising the rate of investment. The TEC pointed out that "from a longer term point of view, the place which deficit finance can occupy in a programme of planned development cannot be of a quantitatively significant magnitude in a country like India."² We are in essential agreement with this observation.

¹Ibid, p. 31.

²TEC Report, Vol. I, pp. 96-97.

3. Comments on the Proposed Financing of the Second Plan

The Second Five-Year Plan, as originally drawn up, has provided for a total developmental outlay in the public sector of the order of Rs 48 billion during the period 1956-61. This expenditure, according to the original intentions of the Planning Commission, is proposed to be financed as shown in Table XV.

Table XV
FINANCE FOR THE PUBLIC SECTOR

	Rs Billion
1. Surplus from Current Revenues	<u>8.0</u>
(a) At 1955-56 Rates of Taxation	3.5
(b) Additional Taxation	4.5
2. Borrowing from the Public	<u>12.0</u>
(a) Market Loans	7.0
(b) Small Savings	5.0
3. Other Budgetary Sources	<u>4.0</u>
(a) Railways' Contribution	1.5
(b) Provident Funds and Other Deposits	2.5
4. Resources to Be Raised Externally	8.0
5. Deficit Financing	12.0
6. Gap--To Be Covered by Additional Measures	<u>4.0</u>
Total	48.0

Source: Second Five Year Plan, pp. 77-78.

It will be noticed that current revenues provide only Rs 9.5 billion. Small savings and Provident fund deposits contribute another Rs 7.5 billion. Market loans, which may be subscribed to by banks or by individuals, are expected to bring Rs 7 billion, while deficit financing is to provide as much as Rs 12 billion. Even if we assume that the uncovered gap of Rs 4 billion is met by additional taxation, the proportion of deficit financing to total outlay is unduly high, being as much as 25 per cent. If we add to this the figure for market borrowings, the deficit in this wider sense would work out to nearly 40 per cent of total expenditure. Even if we assume that at least half the market loans will be derived from genuine savings, clearly expansionary financing will amount to Rs 15.5 billion or 32.3 per cent of total outlay.

The Planning Commission envisaged that sterling balances of the Government of India could be drawn down to the extent of Rs 2 billion. To this extent there will be a mitigation of the expansionary effect of deficit financing. Also if foreign assistance is used for expenditure abroad, there will be an uncompensated inflow of goods which can reduce inflationary pressures. However, if experience to date is any indication, it is extremely doubtful that foreign assistance will be forthcoming on the expected scale during the period of the Second Plan.¹ We are forced to conclude,

¹Grants from the United States often are accompanied by the condition that "counterpart" funds be set up in rupees to be spent on development. In such cases, foreign aid exerts no net deflationary effect. This is true also of aid that has to be returned in the same period, 1956-61.

therefore, that the proposed order of deficit financing is much higher than the Indian economy can stand.

The time at which deficits are incurred is as important as the quantity of deficits. If there is noticeable a tendency for prices to fall, an appropriate amount of deficit can safely be incurred. If developmental outlay in the earlier years of the Plan brings about a substantial increase in output, then some considerable deficit could be incurred in the later years of the Plan. It is true that the First Plan had resulted in an increase in national output. However, when the Second Plan went into operation, there were no deflationary tendencies in evidence. During the First Five-Year Plan, the total deficit spending was of the order of Rs 4.2 billion.¹ A great part of the expenditure was bunched in the last two years of the First Plan, the deficit at the Center being Rs 1.6 billion in 1955-56. Prices, which had fallen in 1954-55, began to rise by mid-1955 and by April 1956 (when the Second Plan began) prices had already reached the 1953-54 level.² And yet a budgetary deficit of about Rs 2.5 billion was incurred by the Union and the States together in 1956-57.³ In 1957-58, there was a deficit of Rs 2.8 billion at the Center alone. In the budget estimates for 1958-59, the deficit at the Center is placed at Rs 1.99 billion.

¹All-India Congress Committee, Economic Review, August 15, 1957, p. 83.

²Ibid., September 1, 1957, p. 7.

³Reserve Bank of India Bulletin, August 1957, p. 753.

Such continuous deficit financing by the Government has been accompanied by a growth in private bank credit. For instance, Scheduled bank credit to the private sector expanded by Rs 1.42 billion between June 1955 and July 1956, and by Rs 1.64 billion between June 1956 and July 1957.¹

The expansion of public and private credit has resulted naturally in an increase in the money supply with the public. The growth in money supply is revealed by the following figures:

<u>Money Supply with the Public as of</u>	<u>Rs Billion</u>
July 1953	18.16
March 26, 1955	19.20
March 31, 1956	21.84
March 29, 1957	23.02
March 28, 1958	23.87

The increase in money supply was 10.7 per cent in 1955-56, 7.0 per cent in 1956-57, and 3.5 per cent in 1957-58. It must be remembered that this increase in money supply has taken place in spite of the heavy deficits in the balance of payments that have materialized since the beginning of the Second Plan. It is these deficits that have neutralized to some extent the expansionary effects of deficit financing undertaken on a scale not warranted by the growth in output and the expansion of the monetary sector.

We referred earlier to the rise in prices since the middle of 1955. Prices continued to rise in the years 1956

¹Ibid., p. 752.

and 1957. The general index of wholesale prices (base: 1952-53 = 100) rose by 13.8 per cent between June 1955 and June 1956, and by 8.3 per cent in 1956-57.¹ The rise in prices levelled off towards the end of 1957. In the early months of 1958, there has been a slight fall in prices. However, as the Government of India's Economic Survey for 1957-58 points out: "Despite the slight fall in prices in recent months and despite the relative improvement in monetary trends ... the economic situation is basically one in which there is a continuous pull, on balance, in the direction of inflation."² It is almost certain that but for the heavy deficit in the balance of payments the price rise would have continued. The Board of Directors of the Reserve Bank of India noted in their Annual Report for 1956-57: "In recent months there have been rather widespread wage claims and there are signs of industrial unrest. It is of the utmost importance that the cost of living and with it the cost of production should be held and a spiralling movement in prices avoided." This statement indicates that monetary stability is being threatened. Speaking of measures for increasing the rate of savings in the economy, the Planning Commission has stated, "It must be emphasized in this context that control of inflationary pressures and the maintenance of public confidence in the stability of the currency are prime requi-

¹Ibid., p. 751. The corresponding figure for 1957-58 is not available. The All-India Consumer Price Index rose from 97 in February, 1956 to 114 in December, 1957.

²Reserve Bank of India Bulletin, March 1958, p. 237

sites of successful policy for mobilising savings." If these are to be fulfilled, it is necessary to adjust the timing and scale of deficits to the monetary conditions prevailing in the economy. Recent Indian experience seems to confirm the theoretical conclusion that deficit financing is a dangerous weapon, to be used only cautiously and sparingly in the course of economic development.

V. SUMMARY AND CONCLUSIONS

A. Introduction

Our aim in this study has been to delineate the role of fiscal policy in underdeveloped countries and to outline a fiscal policy, especially a structure of taxation, that is most appropriate for a country like India. An analysis of the economic problems of underdeveloped countries reveals that a low rate of net investment is the most important factor responsible for the very low rate of growth of income in these countries. Therefore, if economic development is to be accelerated, the rate of investment must be raised considerably. It is assumed in this study that this is the most important objective of public policy. At the same time, since the ultimate goal of all public policy is increased welfare for the great mass of the people, steps must be taken to insure an equitable distribution of the growing national product. This is almost as important an objective of policy as raising the rate of investment.

B. The Role of Fiscal Policy in Underdeveloped Countries

Fiscal policy can play an important role in achieving these objectives. Where economic development is planned to some extent, but to a large extent dependent on private allocation, an appropriate fiscal policy is necessary as an adjunct to investment policy. And if fiscal means are to be used consciously to raise the ratio of savings to national income, public finances must necessarily be conducted on a

functional basis. The functional finance approach thus far put forward by economists such as Lerner, Smithies, and Kurihara has had primary reference to the economically advanced countries. According to this approach, the objective of fiscal policy is to insure conditions of stable growth. Avoidance of inflation then becomes an important objective of taxation; tax policy becomes closely related to credit policy.

An attempt has been made in this thesis to show that a functional finance approach is needed in underdeveloped countries too. We have pointed out, however, that the most important function to be performed is to raise the ratio of savings to national income, and not the mere avoidance of inflation. In a developed economy, it is conceivable that the full-capacity rate of growth may be in excess of the full-employment rate of growth or is less than that rate. In either case, the aim will be to bring them and the actual rate of growth together and maintain conditions of stable growth. Since the per capita income already is fairly high and since, under conditions of stability, the rate of growth of output is fairly satisfactory, the emphasis on stability is warranted in a developed economy. By contrast, in an underdeveloped economy the full-capacity rate of growth chronically falls short of the full-employment rate of growth, giving rise to the twin problems of disguised unemployment and inflation. In these circumstances, a mere avoidance of inflation may merely perpetuate the state of underdevelopment. If raising the ratio of savings to income is adopted

as one of the foremost goals of policy in underdeveloped countries, it is possible, by stages, to bring the full-employment and full-capacity rates together and reduce the volume of disguised unemployment.

C. The Structure of Taxation

Taxation is the most important and powerful weapon at the disposal of the government. If fiscal policy is to fulfill the important objectives that we have postulated, the structure of taxation must be based on principles that are conducive to the attainment of these objectives. A few important canons of taxation are suggested:

(A) The tax system must be capable of mobilizing a great part of the potentially investible surplus in the economy.

(B) Taxation must be such as to lead to a growth in the surplus and to gather for the state a part of the increments in the surplus.

(C) Each person should be asked to pay taxation in accordance with his or her unused capacity to contribute to economic development.

(D) The burdens involved in economic development must be distributed equitably among all classes of the population. This means that the tax system must curtail the consumption of luxuries and check the rapid rise in the consumption of non-necessaries.

(E) The tax system must reduce extreme inequalities of wealth and income and prevent the accumulation of individ-

ual wealth beyond a certain socially defined level.

(F) Two important corollaries can be drawn from the above-mentioned principles: (a) persons in similar economic circumstances and behaving in like manner must be treated equally; and (b) income that is saved and invested in approved directions must be treated more favorably than income that is spent on non-essential consumption.

In Part III of the thesis, an attempt has been made to outline a structure of direct and of indirect taxation on the basis of the principles enumerated above.

1. Direct Taxation

The main recommendations in regard to direct taxation are as follows:

(A) Taxable incomes should be so defined as to include all realized capital gains.

(B) A partial exemption from income tax should be granted to investments in approved directions. A model scheme of exemptions has been worked out to demonstrate that it is practicable to provide for such exemptions.

(C) The problem of economic inequalities should be tackled through the taxation of capital. Two methods may be employed: (a) to prevent the accumulation of wealth beyond a certain limit, an annual tax on wealth with a fairly high exemption level may be levied; and (b) to prevent the growth of a class of rentiers, an estate duty may be levied at appropriate rates.

2. Indirect Taxation

Indirect taxes occupy an important place in the tax systems of underdeveloped countries. The main role of indirect taxation, apart from raising revenue for the government, is to help raise the incremental saving ratio and to curtail the consumption of luxuries. An analysis of the various effects of indirect taxation suggests the following recommendations:

(A) Since it is necessary to apply a general constraint on consumption as well as to cause diversions of productive resources from specific industries to other industries or to public use, a combination of "general" sales taxation and selective excises will be needed.

(B) Necessaries should be exempted from taxation so long as large sections of the population live on the margin of subsistence.

(C) Capital goods must be exempted from sales taxation as a general rule. However, excises may be levied on a few scarce inputs needed in the public sector.

(D) The bulk of excise revenue must be derived from a relatively few widely consumed "mass luxuries" that are likely to have a high income-elasticity of demand and low price-elasticity of demand.

(E) It is not desirable to multiply the number of commodities subject to excises. Excises additional to those suggested above can be levied with some specific objective in view, such as curtailing the consumption of luxuries.

D. The Indian Tax System

An examination of the Indian tax system shows that some important modifications are called for, if it is to be conducive to rapid economic development within the structure of a mixed economy. The important modifications that have been suggested may be summarized as follows:

(A) Realized capital gains should be included in the definition of taxable income. Companies should be asked to pay only one tax, namely, the corporation tax, in addition to withholding the income tax on dividends.

(B) Special provisions should be incorporated in the Income Tax Act to bring under charge considerable income that now escapes taxation. It is suggested that in the case of small shopkeepers and moneylenders gross income could be made the basis of levy, the assessee being given the option to produce satisfactory records to determine net income.

(C) Instead of levying a separate expenditure tax, it would be better to build in a scheme for partial exemption of savings within the structure of the income tax.

(D) In the matter of concessions to businesses, it is recommended that the development rebate should be confined to industries of national importance. It is not desirable to grant tax holidays to new businesses.

(E) The exemption level for the annual tax on wealth should be raised to Rs 500,000 from the present level of Rs 200,000.

(F) As regards commodity taxes, the first suggestion is that necessities must be exempted from sales and excise

taxation.

(G) The principle of taxing industries on the sole ground of benefiting from protection should be abandoned.

(H) Finally, since specific taxes do not respond appropriately to changing incomes and prices, excises taxes should be converted to an ad valorem basis as far as possible.

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