SOME ASPECTS OF TAXATION AND ECONOMIC GROWTH

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"People must eeme te accept private enterprise not as a necessary evil, but as an affirmative good."

—Eugene Black

INTRODUCTION

The problem of rapid economic growth and the impact of taxation on economic growth have been debated throughout the country in recent months. In order to place before the public some thought-provoking material on this subject, this booklet has been compiled. The first article is on the rate of economic growth in India and other countries. This is reproduced from the **Economic Times** of Bombay. The second article is on taxation as a pereentage of national income,, an interesting subject which has given rise to a number of controversies. This article is reproduced from the **Eastern Economist** of New Delhi. The third and fourth articles are on the Super Profits Tax and its effect on the economy. These articles are based on talks delivered under the auspices of the Forum of Free Enterprise in Bombay by Mr. Dhirajlal Maganlal, Vice-President of the Indian Merchants' Chamber, and Mr. S. V. Ghatalia, a leading Chartered Accountant as also a Professor at the Sydenham College of Commerce in Bombay.

The Forum of Free Enterprise hopes that these four articles will place in proper perspective a number of issues raised in connection with taxation and economic growth in India.

RATE OF ECONOMIC GROWTH IN INDIA*

During the first two Five-Year Plans, the rate of growth of our economy as measured by the increase in the real national income — the most important of all the economic indicators — was somewhere around 3.3 per cent per annum. But if account were taken of the increase of population during the same period, the per capita national income showed a rise of just about 1.3 per cent per annum.

Everybody, including the Government and the Planning Commission, is dissatisfied with the admittedly slow rate of growth. That is one reason why, for the Third Five-Year Plan, the target for the increase in the national income was put at more than 5 per cent per annum, which, in terms of per capita growth rate, would work out at around 3 per cent per annum.

It is well known that during the first year (1961-62) of the Third Five-Year Plan, the per capita national income did not show any rise. In fact, there was a nominal fall.

As for the second year (1962-63), no official estimate is available so far. The only systematic unofficial estimate available so far is that made by The Economic Times (June 23. 1963). According to this estimate, the real national income showed a poor rise of 2 per cent against the target of more than 5 per cent. This means that the per capita real national income showed a slight fall against the target of a 3 per cent increase.

In fine, the first two years of the Third Plan have been a period of stagnation. Further, this indicates that the tardy growth rate of about 1.3 per cent (in per capita term) established since the inauguration of planning has not at all shown any signs of the expected acceleration during the Third Plan.

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* Compiled by the Research Bureau of "Economic Times"

The performance is bad enough. However, we cannot realise the full magnitude of this failure unless we judge our performance in relation to other countries in the world. For such a comparison what we need is a comparable set of data not for a year or two, but for a longer period, say, 10 years or so.

Thanks to the efforts of, the statisticians of the United Nations, extremely interesting and useful data of this type are available covering a period of about a decade or so (from 1951 to 1959 for most of the countries). Year-book of National Accounts Statistics, 1981, a U.N. publication, gives such data for 63 countries — 55 non-Communist and 8 Communist. In the table at the end, the data for 55 non-Communist countries have been rearranged according to the rates of growth of per capita real incomes.

These data are, of course, subject to a number of limitations. First, different countries prepare their estimates in terms of different variants of the concept of national income such as gross domestic product at constant market prices, gross domestic product at constant factor cost, gross national product at constant market prices, net national product at constant factor cost, etc. Secondly, the periods covered in the case of different countries are not the same; they extend variously from about 5 to 9 years.

Nevertheless, as indicators of broad magnitudes the data presented in the table are fairly reliable and of great significance.

Thus, although the growth of per capita national income in the case of Burma (3.6 per cent) is higher than that of Portugal (3.5 per cent), no significance can be attached to the higher growth rate of Burma, because the difference of 0.1 per cent is too small. The safest surmise could be that the growth rates of both countries are more or less of the same order. On the other hand, the difference in the rate of growth of per capita income of Italy (5.2 per cent) and France (3.2 per cent) should be regarded as highly significant, all the limitations of the underlying data notwithstanding.

Looking from our point of view, the most important fact that emerges from the table is that with a per capita growth rate of 1.3 per cent per annum, India ranks 41st among 55 non-Communist countries listed in this table. No doubt, one can take solace in the fact that our record is much better than that of the last six countries, whose per capita national income has been falling in recent years. It can further be pointed out that our performance is better than that of the other eight countries which rank below India.

It is, however, more profitable for us to see who and now many are ahead of us, in terms of rate of growth.

Our growth rate in per capita terms (1.3 per cent) has been considerably lower than that of Algeria (5.7 per cent), Venezuela (4.6 per cent), Rhodesia and Nyasaland (4.1 per cent), Taiwan (3.7 per cent), Burma (3.6 per cent), Brazil (3.2 per cent), Turkey (2.9 per cent), Korea (2.8 per cent), and even the Congo (2.5 per cent). It is thus abundantly clear that even among the underdeveloped countries of the world, our record (1.3 per cent) is by no means creditable.

Since it became known that for the two opening Years in succession of the Third Plan, the per capita real income has failed to grow, there has been widespread dissatisfaction in the country at our poor growth rate.

To assuage the public anger, the authorities have started whitewashing their miserable failure. A notable attempt at whitewashing, which appeared in Yojana (June 23, 1963), deserves special mention because it is a prototype of a lot of apologetics that we are going to hear for the next several months. Some of the "explanations" and "correctives" adduced by Yojana to mollify public concern at the growth rate of 2 per cent in 1961-62 are examined below. Quotations from Yojana are put within quotation marks.

(1) "It is equally important not to lose sight of the vital time factor involved. Any attempt to review policies, speed up approaches and remove bottlenecks will not necessarily be reflected in the growth rate figures of the same or the succeeding year." (p 2). This is true in itself

and nobody would deny it. A gestation period of 2 to 5 years is required for all big projects before they go into full production. Thus, projects erected during the first two years of the Third Plan will give us additional production either towards the end of the Third Plan or the beginning of Fourth Plan. But what about the projects built during the Second Plan and particularly those built up during the latter half of the Second Plan? Surely, they should have yielded their fruits in the first two years of the Third Plan.

(2) "Over the period 1950-51 to 1961-62, the increase in agricultural production has been as much as 35 per cent." (p. 2). May be: but the basic point that Yojana forgets is: Is it sufficient for our growing population? If not — as evidently, it is not — does it not signify a major failure of our plans?

(3) Yojana lists a number of handicaps from which we suffer; dependence of agriculture on the "quirks of rainfall and on the individual decisions of more than 70 million farming families;" "one of the lowest land-man ratios in the world," "inadequacy of irrigation, fertilisers and agricultural field-staff," etc. In so far as some of the factors are god-made, they have been known to all for decades. Even the Planning Commission was fully aware of them at the time of fixation of targets for agriculture for the Third Plan. It surely ill-befits the journal published on behalf of the Planning Commission to blame these now for the failure on the agricultural front. And, in so far as the factors are man-made, it Is the Planning Commission and the Government which should be deemed guilty of failure to fulfil the responsibilities undertaken by them, in respect of all these obstacles.

(4) "Yet another crucial fact to be borne in mind is that the quantitative indicators do not tell the whole story. Many aspects of change can be measured mathematically, no doubt; but there are some which are intangible, but not any the less important. Economic outlays or inputs, industrial production, agricultural output — all these can be expressed in quantitative terms. But the changes in outlook and attitudes, the skills and ambitions newly

acquired, the urge to work and improve, all of which go with development, cannot be brought out in ratios and percentages. But their role should not be underestimated. This is especially so in India where the entire process of development is to challenge and shake age-old customs, institutions and inertias.

"Statistics bring out, with an increasing degree of accuracy, what the contribution of each sector of the economy is to the total national product. The aim of India's Plans is not only to increase this total product but also to bring about a shift from agriculture to industry, that is, promote industrialisation. We want the nation's wealth to increase but we also want structural changes in the relations governing production, earning and spending, saving and investment. The task is to raise the standard of living and to see that the fruits of development are widely and equitably disbursed." (Page 2).

This passage has been reproduced here at length because it is typical of the style developed by the Planning Commission; sublime platitudes, couched in a woolly web of words which hardly mean much.

Nobody denies the importance of these intangibles. But if our achievements on the tangible front have been disappointing, perhaps those on the intangible front are much more so. In fact, if the above passage is scanned carefully, it will be noted that even **Yojana** has been careful enough not to claim even in the most indirect way, any achievement on the intangible front, though a careless reader might get an impression that failures on the tangible front have been compensated somewhat by some successes on the intangible front.

Since intangibles do not generally lend themselves to statistical measurement, it is easy for anybody to make any statement and get away with it. However, the record must be set straight on a couple of points which are amenable to statistical treatment.

First, there has been no shift from agriculture to industry, either in terms of the proportion of national income originating in agriculture or in terms of the labour force employed in that sector. For the other intangibles, enough qualitative evidence is available (ranging from Kusum Nair's famous book, **Blossoms** in **the Dnst,** to reports of various official committees, proceedings of the legislatures, etc.) to show that if anything we have been losing ground in this intangible sector.

In fact, we would not be wide of the mark if we say that our statistically provable failure on the tangible front is only a reflection, or one may even say, the direct result of our failure on the intangible front, or, after all, these intangibles are, in the ultimate analysis, **the** source-springs of all the tangibles.

AVERAGE ANNUAL RATES OF GROWTH OF REAL GROSS DOMESTIC PRODUCT: 1951-59.

Country	Total	Per Capita
1. Japan ..	8.3	7.2
2. Jamaica ..	8.9	6.9
3. West Germany ..	7.3	6.1
4. Trinidad and Tobago	9.1	5.9
5. Algeria ..	8.0	5.7
6. Austria ..	5.8	5.6
7. Puerto Rico ..	6.1	5.5
8. Greece ..	6.2	5.2
9. Italy ..	5.7	5.2
10. Israel ..	9.0	5.0
11. Venezuela ..	7.8	4.6
12. Rhodesia and Nyasaland ..	6.8	4.1
13. China (Taiwan)	7.4	3.7
14. Burma ..	4.6	3.6
15. Portugal ..	4.3	3.5
16. Netherland ..	4.6	3.4
17. Brazil ..	5.7	3.2
18. France ..	4.2	3.2
19. Turkey ..	5.9	2.9
20. Finland ..	4.0	2.9
21. Korea ..	5.1	2.8
22. Switzerland ..	4.1	2.8

Country		Total	Per Capita
23. Sweden	..	3.4	2.8
24. Denmark	..	3.3	2.6
25. Luxembourg	..	3.3	2.6
26. Philippines	..	5.8	2.5
27. Congo	..	4.9	2.5
28. Colombia	..	4.6	2.3
29. Norway	..	3.3	2.3
30. Indonesia	..	4.2	2.2
31. Gautemala	..	5.1	2.1
32. Cyprus	..	3.7	2.1
33. United Kingdom		2.6	2.1
34. El Salvador	..	5.5	2.0
35. Belgium	..	2.6	2.0
36. Iceland	..	3.9	1.7
37. Ecuador	..	4.8	1.6
38. Cambodia	..	4.3	1.6
39. Ireland	..	0.9	1.6
40. Thailand	..	4.8	1.3
41. India	..	3.3	1.3
42. Chile	..	3.5	1.1
43. United States	..	2.8	1.1
44. Tunisia	..	2.6	1.1
45. Canada	..	3.7	0.9
46. Peru	..	3.2	0.9
47. Ceylon	..	3.0	0.4
48. Honduras	..	3.6	0.4
49. Pakistan	..	2.3	0.4
50. Argentina	..	1.7	-0.1
51. Federation of Malaya		3.0	—0.2
52. Nigeria	..	4.1	—0.3
53. Paraguay	..	2.0	—0.4
54. Morocco	..	1.6	—1.1
55. Syria	..	1.9	—1.9

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TAXATION AND NATIONAL INCOME

The official estimate of national income, available for 1961-62, places it at Rs. 14,630 crores at current prices. It is now widely known that 1962-63 has been an unsatisfactory agricultural year with very little increase in output, though the organised sector of industry has increased its output by about 8 per cent. A similar rate of rise is anticipated in the tertiary activities as well and, therefore, the total increase in national income may not be more than from two to 2.5 per cent. The most optimistic estimate for 1963-64 also does not place the increase in national income at more than from two to three per cent because in the agricultural sphere it is likely to be the third unsatisfactory year — third in the agricultural cycle which usually runs for five years. (The agricultural output is likely to pick up in the fourth and the fifth years so as to reach a new peak in the last year of the cycle). In other words, the Increase in national income in 1963-64 over 1961-62 may be estimated to be of the order of 5 per cent in real terms.

The rise in prices in 1962-63 over 1961-62 has been up to 2.2 per cent. Assuming a similar rise in prices in 1963-64 as well, due primarily to stagnation in the agricultural sector, a rise of flve per cent may be anticipated in 1963-64 over 1961-62. Thus the total increase in national income in two years at current prices will be nearly 10 per cent, taking the *total* to Rs. 16,000 crores.

According to the Union budget and the budgets of the State Governments for 1963-64, the total tax revenue is expected to be around Rs. 2,100 crores. This gives a ratio of 13.2 in terms of the total estimated national income for 1963-64.

The total taxation effort of this country does not consist of the taxes raised by the States and the Centre only. There are a large number of local bodies which impose additional taxes such as the property tax, the octroi and terminal tax, local fund cess, professional tax and various other taxes and duties. No estimates are available in regard to the probable yields for 1963-64, but an estimate can be made on the basis of the data collected by the Taxation Enquiry Commission. It was estimated by the Commission that the total tax revenue of the local bodies, excluding the Panchayats, in 1951-52 was Rs. 48.73 crores and was nearly one-seventh of the total tax effort of the Union Government. Assuming that the taxes of the local bodies have moved in line with the taxes at the Centre, it is estimated that the total taxation effort of the local bodies in 1963-64 should be around Rs. 170 crores. A similar correlation between the tax revenue of the local bodies and the State Governments also indicates that the local bodies' tax effort would be near about that level. The fact that this figure is, in fact, a conservative estimate is borne out by the study of "Finances of Local Authorities", published in the Reserve Bank "Bulletin" of November, 1962, which stated that the value of rates and taxes collected by 63 local authorities had more than doubled from Rs. 29.4 crores in 1955-56 to Rs. 80.0 crores in 1961-62. It will not be a surprise if the total taxes for this limited sample should rise to Rs. 100 crores in 1963-64; the same trend applied to the totality of local authorities is likely to yield a figure of more, and not less, than Rs. 170 crores.

Again. both the Centre and the State Governments tend to underestimate the tax revenue up to 10 per cent of the budgeted tax revenue (Table I). In the light of the past experience, it may be estimated that the underestimation for the current year's tax revenue at the Centre as well as in the States would not be less than Rs. 210 crores. **Again,** the compulsory deposit scheme, which will siphon off purchasing power equivalent to Rs. 60 crores in 1963-64, is for all intents and purposes another **tax** and in the present exercise must be taken into account. To these levies must be added the volume of deficit financing — another name for forced taxation — which is proposed

for the current year at Rs. 181 crores. Thus, the total tax effort for 1963-64 should be deemed as Rs. 2,721 crores (and not Rs. 2,100 crores) which gives the proportion of the total tax revenue at 17 per cent. of the total national income.

TABLE I.

UNDERESTIMATION OF TAX REVENUE IN UNION BUDGETS

Year	Budget (Rupees crores)	Accounts (Rupees crores)	(2) as a percentage of (1)
	1	2	3
1960-61	676.8	730.1	107.9
1961-62	762.2	875.4	114.9
1962-63	888.5	953.2*	107.3

* Revised estimates.

It must be added that in a vast and variable country such as India, the burden of taxation cannot be uniform either over various regions or amongst various income brackets. The fact that needs to be stressed is that the comparatively low **per** capita income of the people leaves very little room for increased taxation. In fact, the average **per** capita income level conceals a very large number of households which live below the poverty line. If the findings of the 13th round (for the year 1957-58) of the National Sample Survey were to be taken as a guide, it will be found that the rural households with monthly income of less than Rs. 50 constituted nearly 20.47 per cent of the total. Similarly, the corresponding urban households were 12.07 per cent of the total. It means that almost every sixth household in the Indian Union lived below the poverty line and was not able to meet the minimum basic necessities of life. It is these households which hardly have any capacity to bear the brunt of additional taxation.

The same problem may be looked at in another way. There is a vast sector in the economy — the non-monetised sector — which shoulders no responsibility of direct taxation and a negligible part of the indirect taxation. BY non-monetised sector we mean those farmers in the far-flung villages who produce their food crops and consume them, without entering into more than a few monetary transactions throughout the year. An estimate of the non-monetised sector of the national economy can be had from the third round of the National Sample Survey which indicated that about 37 per cent of the value of consumption in India was obtained in kind. The same point was stressed by Dr. B. K. Madan in the Braj Narain Memorial Lectures delivered at Chandigarh in March, 1961, when he stated that "the non-monetised sector may perhaps be one-third of the economy". Even if the non-monetised sector is assumed to be 30 per cent of the economy, the monetised component of the national income would be, in 1963-64, Rs. 11,200 crores (out of Rs. 16,000 crores as estimated above) which against the total tax effort of Rs. 2,721 crores places the crucial ratio at 24.3 per cent.

The problem of the incidence of taxation can be looked at in another way. The burden of taxation is borne In a heavier measure by the urban sector rather than the rural sector in relation to the incomes generated. It has been estimated that the percentage of urban taxes in relation to urban incomes is much higher than the corresponding percentage for the rural incomes. While it is comparatively easy to estimate the urban and rural components of the national income by taking the consumer expenditure data of the National Sample Survey as a guide, it is not an easy task to allocate the total tax effort to urban and rural sectors. An attempt has, however, been made in Table II to split up the total tax revenue into urban and rural components on the basis of some broad assumptions. This tentative exercise clearly illustrates the fact that the proportion of urban taxation as a percentage or urban income is likely to be almost three times the proportion of rural taxation to rural income in 1963-64.

TABLE II.

DISTRIBUTION OF NATIONAL INCOME AND TAXATION IN URBAN AND RURAL AREAS: 1963 - 64

	Urban Areas (Rs. crores)	Rural Areas (Rs. crores)
A National Income (a)	4,000	12,000
B Taxes		
(i) Taxes: Centre & States† (b)	1,100	1,210
(ii) Taxes: Local Bodies (c) ...	150	20
(iii) Deficit Financing (d) ...	72	109
(iv) Compulsory Deposit (e) ...	30	30
TOTAL (B)	1,352	**1,369**
Taxation as a % of National Income	**(33.8%)**	(11.4%)

† Tax Revenue corrected for under-estimation.

(a) Distributed broadly on the basis of the NSS data (13th round).

(b) Urban areas share about half of the tax burden

(c) Local bodies are predominently urban; Panchayats are excluded in this estimate.

(d) Distributed in the ratio of 40 : 60

(e) According to the C.D. Scheme, the impact is likely to fall evenly on the urban and the rural areas.

A usual argument which is presented in favour of increased taxation in India is that the proportion of taxation to national income is lower than in many other countries. Table III shows that the proportion in the case of the UK, the USA. France, Norway and Australia has been more than 20 per cent and that some of the Asian countries such as Japan. Burma, Ceylon and Thailand have also recorded proportions which are higher than that of

India. One facet of higher taxation which is usually ignored in such discussions is the large number of social benefits such as education, child care, health services, housing, old-age pension, national insurance etc. which are made available to the tax-payers in the advanced countries. In the case of the United Kingdom, for example, when the ratio of taxatian to national income was estimated to be around 33 per cent in 1961, no less than 19.4 per cent of the national income was earmarked for expenditure on social services. This also applied to the USA, Canada and other countries.

TABLE III.

TAXATION AS A PERCENTAGE OF NATIONAL INCOME IN SELECTED COUNTRIES

Country	Period	Unit of currency	National Income (In billions).	Tax Revenue (In billions)	Percentage of (5) to (4)
(1)	(2)	(3)	(4)	(5)	(6)
1. **U.K†**	1961	£	21.6	7.2	33.33
2. **U.S.A.††**	1961	$	424.5	128.3	30.22
3. France	1961	Franc	233.0	62.2	26.70
4. **Canada**	1961	$	27.8	5.0	17.99
5. Argentina	1960	Peso	626.0	71.5	11.42
6. Italy	1962	Lira	19,393.0	3311.6	17.08
7. Australia*	1961	£.A	5,814.0	1459.7	25.11
8. Norway	1962	Krone	28.5	6.4	22.46

(Billion =1,000 million)

† Central Government only.

†† Including federal, state and local taxes.

" In millions of national currency.

Again, excessive taxation, it has been discovered in the advance countries such as the USA, the U.K. and Japan, tends to retard economic growth. The recent budgets in the USA and the UK have reduced the taxes so that the people can voluntarily participate in the economic growth and Prosperity of their countries. These steps have been

taken after prolonged discussions and the economists and the administrators have come to the conclusion that higher taxation does not imply necessarily increased economic growth, but in the long run, it slows down the pace of economic growth.

Among the ECAFE countries, the tendency has developed during the fifties to step up the tax revenue. This is illustrated in Table IV which shows in the case of 10 ECAFE countries, including India, the percentage of tax

TABLE IV.

ESCAFE COUNTRIES: TAX REVENUE AS PERCENTAGE OF NATIONAL INCOME

Country	Year	Tax Revenue as percentage of national income
Burma	1951	16.2
	1960	24.0
Ceylon	1950	14.5
	1960	19.9
China (Taiwan)	1951	16.4
	1960	19.4
India	1950	6.9
	1960	9.5
Indonesia	1951	15.7
	1960	11.8
Japan	1950	26.0
	1960	24.7
Korea, South	1953	6.7
	1960	16.6
Pakistan	1950	8.2
	1960	7.2
Philippines	1950	8.0
	1960	12.2
Thailand	1950	6.1
	1960	13.6

Source: Economic Bulletin for Asia and the Far East (December 1962).

revenue in relation to national income between 1950 and 1960. It will be seen that this proportion has increased in every single case except in the case of Japan, Indonesia and Pakistan. None of these cases can be cited to prove that additional taxation has in any way been successful in hastening the progress of these economies. Again, these figures are not exactly comparable because of the different systems of taxation prevalent in the different countries. India, as usual, is shown as one of the least-taxed countries ignoring some of the essential components which must be included for purposes of comparability. It is also pertinent to note that Indian poverty is much greater in width and depth than poverty in Ceylon or Burma.

A note of warning needs to be struck for those who have tended to compare hastily and without thinking the proportion of taxation to national income of this country to other advanced countries in order to prove the thesis that the taxable capacity of this country is much larger and that additional burden can be borne by the people only on the strength of this overall percentage. The urban areas in particular and the monetised sector of the economy in general have, as indicated above, borne increasingly higher burdens of taxation and any further imposts will tend to throttle the flow of savings and investments from those income brackets which have pioneered, in the past, the economic growth of the country. In certain income groups, the present rate of taxation, moreover, tends to be destructive in the sense that all incentives for harder work are being lost and the erosions in income act as a great disincentive.

(Reproduced, *with* kind *permission* of the editor, from '*Eastern* Economist' of June 14, 1963. *Although* the *Compulsory* Deposit Scheme, referred to in the article has been substantially *modified since* publication of this *article*, it does not materially *affect* the *arguments* and conclusions.)

THE ECONOMIC EFFECTS OF THE SUPER PROFITS TAX

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The economic effects of Super Profits Tax on the capital market and the investors require careful study in the context of our economic development. The Finance Minister, in his Budget speech, enumerated three objectives of his tax measures; (1) increasing the defence potential of the country: (2) increasing production within the country; (3) to help industrialisation and capital formation. But in recent years no single factor has contributed so much to the unsatisfactory state of affairs in the capital market as the Super Profits Tax.

Most of the people in the country had reconciled themselves to the possibility of increased taxation in view of the enhanced defence obligations. It was also hoped that the Finance Minister would so orientate his taxes as not to hamper productive investment which forms the backbone of our defence efforts.

The events subsequent to the presentation of the Budget for 1963-64 had the opposite effect of what the Finance Minister intended. The stock markets are comparatively dead and share prices are down. The S.P.T. has turned out to be the largest single factor in the current investment stalemate.

The proposal for the levy of the Super Profits Tax illustrated how the Exchequer often creates conditions which are not conducive to savings and investment. Under the Super Profits Tax scheme, a company is liable to pay Super Profits Tax when its income after the deduction of income tax and super tax exceeds 6 per cent of the paid-up share capital and reserves. Though, to a layman, on a plain reading of the Super Profits Act the tax is supposed to be on "super" profits, the Government has its own notions on "normal" proflts and "super" proflts. According to Government thinking, only up to 6 per cent of the paid-up share capital after payment of taxes is normal proflts. A sample survey conducted by the Reserve Bank of India covering 1,001 companies whose estimated proflts stood at Rs. 110 crores per year after payment of tax, for a capital and reserve of Rs. 1,060 crores, indicated that 10 percent is the normal rate of profit for a company. The Government's view on profits is erroneous and what is in fact taxed are not "super" profits, but normal profits.

At present, there is a serious crisis of confidence in the stock market and an investment stalemate has followed. There has almost been a landslide in the market since the announcement of the Budget and the index number of variable dividends of industrial securities dropped sharply from 195 in May 1962 to 171 in December 1962 (due to the border trouble and uncertain climate) and with the introduction of the latest Budget to an appallingly low level of 159 in 1963. The loss to investors based on 20% fall in value of share market will work out at Rs. 360 crores on total value of Rs. 1,830 crores. The pruning of the dividends has fully shaken the confidence of the investing public. It was expected that the Government would learn at least from the past experiences and the reactions of the capital market to the various "socialist" budgets introduced since 1956. From the year 1952/53 (100) the index had recorded progressive rise and stood at 141 in 1956. But the Budget which was presented in 1956 and which heralded the era of the so called "progressive taxation" cast a shadow and the market registered a sudden slump by 25 percent to 117. This was serious enough. Attempts were made to lift this pall of diffidence. A new Finance Minister gave certain strategical tax concessions such as the withdrawal of wealth tax on companies, reduction in bonus tax and withdrawal of C.D.S. applicable to companies-and the suspension of expenditure tax. These measures, of course, revived the confidence in the market, capital became more responsive and floatatiop of new issues went up from Rs. 35

crores to Rs. 60 crores annually and also encouraged foreign participation in equity capital.

With the introductioq of the Super Profits Tax, not only have the dividends declared by the companies been slashed. but also the new issue of capital in the market shows an alarmingly declining trend. Out of 120 companies who have declared dividends this year, 34 big corporations have already reduced their dividends by 10 to 25 per cent.

The Government has created an impression that the main impact of the burden of this tax will be on a few big companies. This is not so. The principle behind this tax measure is not "bearing capacity" but "earning capacity". The tax is inequitous and is a tax on efficiency, because many of the thousands of small companies have very small capital base but have a high earning capacity because of their initiative, enterprise and operational efficiency. The tax will severely affect such small companies, and the small investor will be the most hard hit. In 1960-61, the total number of companies assessed to tax was 9,959. The number of .companies with income upto Rs. 2 lakhs was 8,500. Those with income between Rs. 2 lakhs and 5 lakhs was 659 and over Rs. 5 lakhs, 780. The burden borne by them relatively were 10%, 8% and 82% out of total tax burden of Rs. 122 crores. The additional taxation envisaged for the corporate sector for 1963-64 was put at Rs. 196 crores, to be shared by them in the order of Rs. 19, Rs. 15 and Rs. 162 crores respectively. The Super Profits Tax comes over and above this.

The seventh quarterly survey of the "Economic Times" on market valuation of new shares shows that two-thirds of the shares issued since January 1959 are now being quoted at or below par and the new shares which had shown appreciation of 9.6 percent at the end of March 1963 now stand only 2.5 per cent above their paid-up value. Of the 157 new scrips traded officially or unofficially on the 7 stock exchanges (Bombay, Madras, Calcutta, Delhi, Hyderabad, Indore, Ahmedabad) 89 are quoted at discount, 14 at par and the remaining 44 at a slight premium. Thus, roughly 4 out of every seven new shares are now quoted below par. And in respect of the loss incurred by the investors, one has to remember that no dividends have been paid in respect of many of the new shares. Similarly compared to the issue of new capital in the first six months of the previous years, in 1961 there were 53, in 1962, 44 and in 1963 only 14.

The effects of S.P.T. are already being felt. The tax measure will seriously affect the ploughing back of proflts by the companies. This will also give a serious blow to the participation of foreign capital and repayment of loans, both foreign and domestic. The rate of interest to be paid on the bank borrowings is often 8 or 9% and the 6 per cent deduction will seriously hamper a company's capacity to repay borrowings. The tax is inequitous also because it makes no distinction between companies having low capital base but high earning capacity and companies with high capital base and low earning capacity. This tax has rightly been described as a killer of efficiency.

In a forthright editorial, "Economic Times" of July 4, 1963, points out, "the budget has left a bitter trail of devastation in the corporate sector in a brief one quarter of a year. It has resulted in a psychology of frustration among industrialists and business men. The S.P.T. has lost much of its significance as a revenue raiser proposition and its political bias is certainly no justification for retaining a measure which was viewed with such grave misgivings even at the start. To allow the present drift to continue indifinitely will be gravely to imperil not only development and defence, but some of the larger social objectives before the country."

THE SUPER PROFITS TAX THREATENS SURVIVAL OF PRIVATE SECTOR

S. V. GHATALIA *

Swift, in his "Gulliver's Travels," wrote 240 years ago, "Whoever could make two ears of corn or two blades of grass to grow upon a spot of ground, where only one grew before would deserve better of mankind, and do more essential service to his country, than the whole race of politicians put together."

This statement aptly applies to the current economic scene in our country. In times of emergency, what we require is more effective use of resources in our struggle against the Chinese Communists.

The trend of direct taxes over the past few years reveals that politics dominates our entire economic scene. The political forces have become so dominant as to believe that they can subjugate, control and govern the economic forces. Herein lies the tragedy. It is a historical fact that ultimately economic forces always prove more dominant than political forces. Therefore, a wise policy for the Government is to respect the natural laws in determining the shape of things economic. The issues of morality and sentiment have too often been mixed up with considerations of scientific approach. Morality is no doubt important but having laid down the broad social objective, it is only the scientific approach which should govern the economic policy of our country.

Dr. Ludwig Erhard who achieved a miracle of converting a crushed and vanquished country that West Germany was into a victor in the economic field, in his book. "Economics of Success", observed: "We shall be doing our coun-

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try a real and lasting service if we can establish an economic order, which is purged of the theorising and bureaucratic spirit which everyone hates and which enables people to act freely and in response to a sense of their social responsibilities."

It is the temper of science and not the temper of politicians which should govern the decisions relating to economics. It is the spirit of the science that can provide solutions to our problems.

The levy of the Super Profits Tax was justified by the Finance Minister on the ground that in our system of corporate taxation there is no correlation between the rate of *tax* and the percentage of profits. In order to take a balanced decision to devise an equitable tax policy, it is equally essential to take into account other relevant correlations. If we accept the principle of relation between the rate of tax and the percentage of profit, then those companies who get a return of less than six per cent on their capital should become eligible for reduction in income tax and super tax. A flat rate of tax arid the Super Profits Tax cannot co-exist together in the present form.

It must be accepted that return on capital is a long-term concept and, therefore, if there arises a "super profit" over a fairly long period of time, then and then only the Super Profits Tax could be levied. We have examples before us of companies which for the last ten to fifteen years have not paid any dividend to the shareholders, and which have recently started paying four to six per cent dividend. With the imposition of the Super Profits Tax, the shareholders are deprived of making good the arrears of even so-called six per cent fair return on their investments. Conversely, companies which have made "Super" Profits till now and whose profits are now declining would have reaped the harvest as the incidence which ought to have fallen on them would fall on others. This shows the danger of isolating a brief period and drawing conclusions on that basis. This tax will also hit growing companies which have just entered the profit-earning stage and whose shareholders now will have no chance of recouping the

return which they have foregone in the development stages of the company. Thus, if principles are to be applied in a spirit of fairness, there should have been a carry-forward and backward of deficiency for five to seven years.

It is not appreciated that tax on companies is in effect a tax on its shareholders. An investment in the corporate sector is not necessarily by people in the bracket of high income or large wealth. Many a common man has invested his savings in the corporate sector in the expectation of earning a fair return on capital. This new levy has completely altered the investment climate in this country. It is an indisputable fact that the development of the corporate sector bears direct relation to the degree of industrialisation of a country. In modern times, any large business must, of necessity, have a corporate form of organisation. The incidence of this new tax is a great disincentive for the corporate sector. **Dr. Kaldor** in his report on Indian Tax Reforms, as early as 1956, stated:

> "India, like most western countries, has been in the grip of vicious circle as far as progressive taxation is concerned; evasion and avoidance by cutting down potential revenue led to higher nominal rates of taxation and this in turn to further evasion and avoidance and still higher rates. It is a vicious circle of charging more and more on less and less."

When Dr. Kaldor made his suggestions seven years ago, the rate of company taxation was 43.8 per cent and the income tax on companies was refundable to the shareholders. As against this, me have, at present. on account of the Super Profits Tax, the highest rate of 80% in certain ranges of income and none of it refundable. One will, therefore, appreciate the steepness of the rise in corporate taxation. The percentage of corporate tax to total tax on income was 39.88% in 1960-61 and it has risen to 51% in 1963-64.

It is also not appreciated that there is no correlation between the real income and the taxable income with the result that the real incidence of tax is very much higher than the apparent incidence of tax. In case of companies, expenses before commencement of business are not allowed to be deducted. Suppose such expenses amount to Rs. 2 lakhs, The company will have to earn further Rs. 10 lakhs to offset the loss of this Rs. 2 lakhs. The burden of tax is considerably enhanced by framing a law which is not equitable and by administering it in such a manner as to artificially inflate the income., e.g., by disallowance of legitimate business expenditure like technical fees, remuneration to directors etc.

The last budget has been described as a budget for defence and development of the country. The Finance Minister, in his budget speech, stated that: "The growing claims of defence and development cannot be met except on the basis of an expanding volume of production. By far the greater part of the responsibility for increasing the production rests with the Private Sector." In this context, it is relevant to examine what scope is left to the Private Sector for its development with the crushing incidence of this new tax. Even though the Super Profits Tax will cause considerable drain on the finances of a company, even a small mercy like suspension of Section 104 in regard to the compulsory distribution of dividend is not even thought of.

One of the strongest objections to the Budget is that the new tax will cause serious disturbance in the cash flow position of companies who have recently undertaken expansion plans. These companies will find it extremely difficult to meet the commitments already entered into with the financial institutions.

Those companies which are thinking of expansion plans are forced to defer their expansion because of longer pay-back period, the refusal of the foreigners to participate In the capital and the difficulties of obtaining share capital in the present investment climate.

The difficulties and inequities in our tax structure are mainly attributable to the fact that accounting concepts of profit and capital are not accepted for the purposes of framing laws with the result that the gap between the legal concept and the accounting concept is day by day widen-

ing. Under the new levy, it will be seen that the capital employed as computed under the Second Schedule will never correspond with the real capital employed. All normal concepts of capital employed have been ignored in framing these rules, e.g., while computing reserves, only the reserves at the beginning of the period must be taken which will exclude any additions in the reserves during the year. The adjustment for increase or decrease in the share capital is permitted but not so in respect of the reserves. Secondly, the balance to the credit of Profit and Loss Account is not considered to be capital. Thirdly, any provision set aside by the company which is not deductible for computing taxable income may not be regarded as reserves. Thus companies are hit not only with the high rate of tax but also with the artificially high amount of Super Profit computed under highly defective rules of computation of income and capital. Surely, taxing the subject well is not necessarily inconsistent with taxing the subject properly.

It is also naively believed that the imposition of the Super Profits Tax would check profiteering and would help to hold the price line. The high rates of taxes are an incentive for profiteering because an individual also measures his return on capital after tax and not before tax. Therefore, higher the rate of tax, the higher the price which he will charge so that he can maintain his return on capital despite the increase in tax.

Another serious effect of the Super Profits Tax is that the flow of foreign capital in the shape of equity participation and long-term loans will stop. Loans will be denied because of longer pay-hack period and the consequent incrsase in the risk. Capital will be denied due to low dividend income. In respect of such foreign equity capital which has already come, the new levy of tax almost amounts to breaking faith with those, who trusting our Government, invested their money in India. The Super Profits Tax will hit very seriously those companies which are rendering services. e.g., technical companies, managing agency companies, advertising companies et~which do not have large capital. Since the Super Profits Tax is computed with reference to capital, practically all their profits will become "super" profits. In addition. private companies which are family companies with low capital structure and whose capital requiraments and finance are met by loans from shareholders will also be hard hit.

The proposed rate of tax comes to 75% on profits between 6 to 10% and 80% on profits above 10%. The actual rate will be much higher and may reach 100% because the Income-tax Officer is given power to increase the total income for the purpose of the Super Profits Tax, by expenditure incurred on account of commission, entertainment and advertisement to that extent, if such expenditure, in his opinion, is excessive having regard to the circumstances of the case.

In fine, the Super Profits Tax will spell gradual but certain extinction of the Private Sector. It will retard industrial development; throttle enterprise and initiative; penalise the honest and the efficient. This tax measure, therefore, needs to be given up immediately in the interests of economic development and social justice.

The views expressed in this booklet are not necessarily the views of *the* Forum of *Free Enterprise.*

"Free Enterprise was born with man and shall survive as long as man survives."

—A. D. Shroff

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The Forum of Free Enterprise is a non-political organisation, started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklet. and leaflets, meetings, essays competitions, and other means as befit a democratic society.

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