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The Impact of Indian Taxation system on its Economic Growth

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Abstract

Tax structure in India *is a three tier federal structure. The central government, state governments, and local municipal bodies make up this structure. Article 256 of the constitution states that "No tax shall be levied or collected except by the authority of law". Hence, each and every tax that is collected needs to backed by an accompanying law.* ***Tax structure in India*** *is a three tier federal structure. The central government, state governments, and local municipal bodies make up this structure. Article 256 of the constitution states that "No tax shall be levied or collected except by the authority of law". Hence, each and every tax that is collected needs to backed by an accompanying law.Interestingly, the tax system in India traces its origin to the prehistoric texts such as Arthashastra and Manusmriti. As proposed by these manuscripts, the taxes paid by farmers and artisans in that era would be in the form of agricultural produce, silver or gold. Based on these texts, the foundation of the modern tax system in India was conceptualised by the Sir James Wilson during the British rule in India in the year, 1860. However, post-independence the newly-established Indian Government then soldered the system to propel the economic development of the country. After this period, the Indian tax structure has been subject to a host of changes.*

Keywords:-**India, Tax structure,**Indirect Tax, Direct Tax, Purchase Tax, Sales Tax

Introduction

.A tax is a financial charge or other levy imposed on an individual or a legal entity by a state or a functional equivalent of a state (for example, tribes, secessionist movements or revolutionary movements). India has a well-developed tax structure with a three-tier federal structure, comprising the Union Government, the State Governments and the Urban/Rural Local Bodies. The power to levy taxes and duties is distributed among the three tiers of Governments, in accordance with the provisions of the Indian Constitution. The main taxes/duties that the Union Government is empowered to levy are Income Tax (except tax on agricultural income, which the State Governments can levy), Customs duties, Central Excise and Sales Tax and Service Tax.The principal taxes levied by the State Governments are Sales Tax (tax on intra-State sale of goods), Stamp Duty (duty on transfer of property), State Excise (duty on manufacture of alcohol), Land Revenue (levy on land used for agricultural/non-agricultural purposes), Duty on Entertainment and Tax on Professions & Callings. The Local Bodies are empowered to levy tax on properties (buildings, etc.), Octroi (tax on entry of goods for use/consumption within areas of the Local Bodies), Tax on Markets and Tax/User Charges for utilities like water supply, drainage, etc.

Types of Taxes in India

From income tax to custom duty, there are a variety of taxes applicable to Indian citizens under the nation's taxation system. However, almost all taxes under the Indian taxation system can be primarily distinguished under two categories: direct and indirect taxes.

- **Direct Taxes:** These forms of taxes are levied directly on the taxable income generated by individuals and corporations. The importance of these taxes are that they are paid directly to the government and make up a significant portion of India's tax generated revenue. An important thing of note is that while they are known as 'direct' taxes, the responsibility of submitting these tax amounts rests on the taxpayers themselves.

  Some of the most important direct taxes are the income tax, corporate tax, capital gains tax, property tax, entitlement tax and such.

- **Indirect Taxes:** The other form of taxes are not levied directly on a taxpayer's income but rather indirectly when they avail or purchase goods and services. These taxes are included and paid by the consumer to the service provider or goods seller. The same amount is then paid by these parties to the government, hence the term 'indirect'.

  One of the most important indirect taxes is the Goods and Services tax (GST) which has subsumed a large number of indirect taxes that existed before 2017. Apart from GST, there is also Dividend Distribution Tax, Custom Duty, Securities Transaction Tax and such.

Importance of Taxes

Now that we understand the types of taxes in the Indian tax structure, let us review the importance of taxes as understood by this distinction.

Importance of Direct Taxes

Direct taxes display the importance of taxes by reducing income equalities with its progressive tax structure. Citizens are taxed in proportion to their economic circumstances, thereby encouraging social and economical equality. Moreover, with direct taxes, taxpayers remain aware of how much tax they can be expected to pay in a financial year and prepare well in advance. Direct taxes are also useful in controlling inflation as any change in their rates can help in regulating demand and supply in the economy.

Importance of Indirect Taxes

The importance of taxes for the government when it comes to indirect taxation is that they are an automatic function that accompany the buying and selling of goods and services across the country. They are therefore easy to collect and convenient for both taxpayers and the tax collection authorities. They also help broaden the country's net of tax liabilities, gathering contributions from those sections of society that are otherwise exempted from direct tax.

Role of Taxation in Financing Economic Development | Economics

Tax policy plays two important roles in financing economic development. One is to maintain an economy at a higher employment level so that the saving capacity of the people is raised with an increase in income per head.

The second is to raise the marginal propensity to save of the community as far above the average propensity to the maximum extent possible without discouraging work effort or violating canons of equity. Savings can be generated in two ways: by increasing real output or by a reduction in real consumption.

There is considerable disagreement among economists and policymakers about the usefulness, or necessity of taxation in raising resources for financing economic development in developing countries like India. At the early stage of development, when the rate of raising is low, there is need for compulsion in forcing people to consume less and save more. Only through taxation it is possible to generate forced saving which is so essential for accelerating the rate of capital formation which is the sine qua non of high rate of per capita income growth. Tax policy to raise the MPS above APS is concerned with the design and implementation of taxes to reduce private consumption. Tax revenue as a percentage of GNP is low in most developing countries, averaging between 15—20%, compared to 25—30% in developed countries. Moreover, direct taxes especially taxes on income, are a minor source of tax revenue compared with indirect taxes.

The proportion of the population that pays income tax in developing countries is correspondingly low, averaging about 10% compared to the vast majority of the working population in developed countries which constitutes between 20 to 40% of the total population. There would, therefore, appear to be a greater scope for using tax policy to raise the level of aggregate saving relative to income. Two important points may be noted in this context.

Nature of tax system

First, the rudimentary nature of the tax system in developing countries is partly a reflection of the stage of development itself. Thus, the scope for increasing tax revenue as a proportion of income may in practice is limited.

Measuring the tax base

Secondly, there are the difficulties of defining and measuring the tax base and of assessing and collecting taxes in circumstances where the population is scattered throughout the country, and primarily engaged in producing for subsistence and where the illiteracy rate is also high.

There is also the fact that, as far as income tax is concerned, the income of the vast majority of income-carers is so low that they fall outside the scope of the tax system. Whereas 70% of national income is subject to income tax in developed countries, only about 50% is subject to such taxation in developing countries.

Progressive Income Tax and Saving

In this context, we may cite the examples of progressive income tax which will discourage work effort if the substitution effect of the tax is stronger than the income effect; and to the extent the high marginal rates of tax fall primarily on the high-income groups (i.e., rich people) with low propensities to consume, saving may fall by nearly as much as tax revenue rises.

To avoid such large reductions in private saving, an expenditure tax on high income groups, which exempts saving from taxation, is a preferable alternative to a progressive income tax, but the disincentive effects on work effort are not necessarily avoided. This is so because if the expenditure tax encourages saving, the tax rate must be higher to yield the same revenue as the income tax. If people work to consume and the prices of consumption goods are raised, work effort will be curtailed if the substitution effect of the change is stronger than the income effect. The more successful the expenditure tax is in stimulating saving out of a given income, the higher must be the rate of tax to keep the economy from the two taxes equal, and the greater the discentive to work effort is likely to be.

In general, the most effective tax policy to raise the level of saving relative to income would be to impose taxes on those with high MFC, viz., the poor, keeping in view the obvious considerations of equity.

For achieving the best possible results, i.e., promoting growth without affecting the incentives to work hard and save taxes should be imposed on all non-profit incomes and luxury consumption. However, since most people in developing countries do not have taxable income (due to complete absence of agricultural income tax, low per capita income and widespread tax evasion and avoidance), the contribution of direct taxes is low. In India, for example, the contribution of direct taxes to total tax revenue was 18.5% in 1995-96. This means that 81.5% of tax revenue was derived from indirect taxes. So, in order to raise adequate resources for development, the government is forced to extend the coverage of indirect taxes on mass consumption goods. Furthermore, since agriculture is the backbone of the economy, and since huge amount of investments usually made in agriculture and allied activities in developing countries, agricultural taxation has to play an important role in resource mobilisation for planned economic development.

Agricultural tax

The predominant importance of agriculture in developing countries makes agricultural taxation a potentially significant source of tax revenue and a means of transferring resources into productive investment. There are various instruments for taxing agriculture, including taxes on land area, on land value, on net income and on land transfer. If the object of the government is to raise revenue, then agricultural marketing and export taxes are probably the most efficient and the easiest to collect. In theory, land taxes are probably the most desirable way to transfer resources from agriculture. But, in practice, land taxes are not important as a source of tax revenue. In a modern market-based economy like that of India, the balance between direct taxes on income and indirect taxation on expenditure and trade is heavily weighted in the direction of the latter, particularly in the form of import duties and sales taxes.

Business Taxes

Such taxes are easy to collect and administer but again business taxation may merely replace one form of saving for another. The MPS out of profits is usually high. The main justification for corporate taxation is to retain control of resources which might otherwise leave the country if the business is foreign-owned or to substitute public for private investment on the grounds that the public investment is more socially productive than its private counterpart.

Difficulties

However, taxation as a method of development finance creates certain problems. While involuntary savings may increase through financed reduction in consumption, voluntary savings may fall because individuals may try to protect their living standards by maintaining their existing consumption levels. This is likely to reduce the flow of funds to the private sector. Moreover, taxation has a negative effect on incentives to work hard, save and take risk. So, work effort, saving and investment in venture capital (i.e., new enterprise) will fall. Moreover, taxation on agriculture may affect agricultural improvement. Instead of adopting measures for raising agricultural productivity through investment, farmers may prefer to consume more and save less.

Thus, it is absolutely essential to evolve an ideal tax system that is unlikely to have any adverse effect on work effort, saving, investment and enterprise (risk-taking) and does not violate the accepted notion of equity.

The impact of direct tax on economic growth

The direct tax is one of the important sources of government revenue. Further it also impacts directly the disposable income of individuals. If direct tax rate is increased by the Government, people start saving for investment purposes. Due to this behavior of individual's income generation process of economy is hampered. Particularly this is true for luxury commodities. This decreases the production of luxury commodities in the economy and as a result also adversely affects the GDP and standards of living. However on the positive sides, if proper deductions are allowed based on investments, it leads to capital formation in the country. Thus, broadly following are the positive sides of direct taxes on the economic growth:

- Better capital formation
- Inducement of saving and investment
- Surety of Government's revenue growth
- Increase in planned expenditure of government
- Decrease in inflation rate due to lesser availability of disposable income to persons
- Timely availability of revenue to the Government

Impact of indirect tax on economic growth

Since the burden of Indirect taxes directly fall on the consumers, it directly impacts the cost of goods and services. Thus, indirect tax increases the efficiency of the producers, since to maintain their demand they will have to put their full efforts towards cost cutting measures. Further, this effort of producers also brings proper utilization of resources in the economy. The consumers are at freedom to select products at their choice, thus healthy competition also grows in the economy. Thus, broadly following are the positive sides of indirect taxes on the economic growth:

- Better utilization of resources
- Increase in efficiency of producers
- Growth of healthy competition in the market
- More freedom of choice to the consumers
- Increase in demand for luxury goods
- Increase in standard of living of people

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The Road Map of new budget 2014

The new Government has many challenges to face. Food inflation, economic growth, reduction in fiscal deficit, inviting more foreign capital flow, infrastructural development are some of the special emphasis areas.

Fiscal deficit has been aimed at 4.1% which is expected to reduce to 3% by 2014-15. It is worth noting that fiscal deficit was 5.7% in 2011-12,dropped down to 4.8% in 2012-13 and to 4.5% in 2013-14. Thus, from high peak it is dropping downconsiderably. However, this reduction in earlier year was basically due to curtailing down the Government expenditure rather than increasing Government Revenue.

- More excise duty on Cold drinks and tobacco products
- Reduction in excise duty on packaged food, footwear, LCD/LED TV sets,
- Deduction for housing loan interest raised from 1.5 lakhs to 2 lakhs
- Tax exemption limit raised from 2 lakhs to 2.5 lakhs and for senior citizens up to 3 lakhs
- Investment limit under section 80C rose from 1 lakh to 1.5 lakhs.
- PPF limit has been raised to 1.5 lakhs
- No changes have been made in the tax rates.
- The advance ruling Authority has been strengthened
- The scope of Income tax settlement commission has been enlarged
- It has estimated that net loss due to direct tax amendment will be 22,200 crores.
- Introduction of GST has been given preference

Conclusion

While the importance of taxes to the country's government cannot be overstated, the central government also makes various provisions to help citizens save income taxes in India. One of the most effective means of saving income tax in India while safeguarding the financial future of your loved ones, is to avail a trusted term insurance plan. While the importance of taxes to the country's government cannot be overstated, the central government also makes various provisions to help citizens save income taxes in India. One of the most effective means of saving income tax in India while safeguarding the financial future of your loved ones, is to avail a trusted term insurance plan.In short, the system of tax policy in developing countries like India is likely to exert considerable influence on saving and investment the two crucial determinant of economic growth. So, the primary objective of tax policy in such countries should be to transfer financial resources from the private to the public sector as much as possible with minimum adverse effect. There is wide agreement among economists that in countries like India there is an untapped tax potential.

In other words, there is considerable scope for broadening and deepening the tax system by improving the tax structure and by strengthening the tax collecting machinery.

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