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**CAPITAL TAXATION
IN A DEVELOPING
ECONOMY (INDIA)**

CAPITAL TAXATION IN A DEVELOPING ECONOMY (INDIA)

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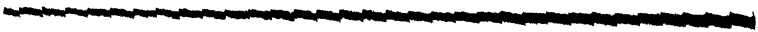
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TO MY MOTHER

PREFACE

THE subject of capital taxation in the context of development was first suggested to me by Mr J. J. Anjaria, when I told him of my intention to work for a research degree, but it was only after I joined the London School of Economics that I was able to plan out the course of my research on the subject. The study, as now published, is a somewhat revised version of the thesis submitted to London University. I have excluded some of the portions, particularly those in the section on India and I have contented myself with footnotes wherever they were necessary.

The entire research, whose product this study is, was done at the London School of Economics, where I had constantly the benefit of advice from and discussion with members of the staff and fellow research students. I must thank particularly Mr Alan Peacock (now Professor of Economics at Edinburgh) and Dr Vera Anstey, who were always most willing to discuss things with me and led me so many times out of blind alleys. Also, I must acknowledge my debt to Mr Arthur Lerner, a research colleague at the School, whom I never found unwilling to discuss my difficulties. On my return, I had the rare privilege of being asked to assist Mr Nicholas Kaldor in the preparation of his report on Indian taxation. I am glad to have had this opportunity because it helped me to think further on the ideas with which I had been struggling in the course of my research. I have not found it necessary however, to revise at this stage any of the conclusions I arrived at earlier.

During my stay in London, I was allowed access to the libraries of the London School of Economics, India House and the Board of Inland Revenue. The immense courtesy and consideration which I always received in these libraries are an experience I shall ever remember.

Here in Baroda, I have to express my thanks to my colleagues in the University, Dr A. H. Somjee and Mr H. C. Malkani, for going through the revised typescript, and to Mr H. S. Akolkar for giving me all possible assistance, particularly in typing.

A postscript has been added to make the book completely up to date.

BARODA
July 1957

I. S. GULATI

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INTRODUCTION

GOVERNMENTS are known to tax and to spend. At times they borrow in order to spend. For a long time, government expenditure even if incurred for the express purpose of creating capital assets was treated as a low priority outlay and tended to be equated with the community's current consumption expenditure. There was also another reason for according this treatment to government's capital expenditure. Capital was generally understood as revenue producing, and government investment which usually took the form of public works was seldom productive in this restricted sense of the term.

Since governments were supposed to be spending on consumption, they were generally exhorted to economise to enable the rest of the economy to save and to invest. Keynes put a much more favourable interpretation on the government's spending activities. Having discovered the tortuous way in which the identity between saving and investment tended to be maintained for the economy in the aggregate, Keynes sensed positive virtue in the government's spending operations as a means of bridging the gap in aggregate demand which tended to develop in a private enterprise economy operating under normal conditions. Keynes conceived of government spending as a lever of central control very necessary 'to bring about an adjustment between the propensity to consume and the inducement to invest.'¹ But even Keynes, oppressed by the urgencies of his time, did not pay sufficient attention to the content of government spending. Government spending interested him primarily because it constituted an autonomous variable, operative independently of the variations in income, rate of interest, or marginal efficiency of capital. It would be in order to say that in the Keynesian scheme of things it was of little consequence whether government expenditure represented building up of capital assets or not.

The Keynesian indifference to investment as such was accountable by the fact that the problem which Keynes was out to solve in the 'thirties was one of lower national output brought about not by the dearth of capital but in spite of the availability of capital. In the period following World War II, however, the

¹ *The General Theory of Employment, Interest, and Money* (1936), p. 379.

problem in most of the countries has been one of insufficiency of capital. This applies both to the developed and the underdeveloped parts of the world. But in the developed economies the problem has high-lighted itself primarily because of a phenomenal rise in the current expenditures of the government, which combined with the consumption demand of the private sector do not leave enough for investment to proceed at a steady pace. In the underdeveloped economies, on the other hand, the problem remains essentially one of the precariousness of the margin over and above the consumption demand based on extremely low standards of living.

In the post-war era, the investment aspect of government expenditures has started receiving some attention as the socio-political forces have directed the world's eyes towards the problems of underdeveloped economies where lower national output is accounted for, *inter alia*, by the dearth of capital and where the marginal social efficiency of capital for government investment outlays in the earlier phases of economic development is generally agreed to be very high. In view of the overall scarcity of resources in these economies, the question of securing finance for government investment programmes assumes critical importance. Taxes and other sources of government finance have to be viewed from this angle. The present study which concentrates only on a specific branch of taxation is an attempt in that direction.

Capital taxation forms the subject matter of this study. I have found it necessary to devote Part I of this study to the definition of the concepts used and to the examination, on a general theoretical plane, of capital taxes. Having built up the theoretical framework, I proceed to appraise in Part II of this study, the role which capital taxes may play, especially in harnessing scarce resources in an underdeveloped economy for purposes of public investment.

India is an underdeveloped country. The standard of living in the country is, in general, extremely low compared to the standards prevailing in the advanced countries. The government in India has in recent years been converted to the view that it should participate actively in the sphere of investment in order that the pace of the country's economic development can be accelerated. I have therefore devoted a good part of Chapter 6 to the examination of the financial scheme of the government's First Five Year Plan. No direct reference has been made in this study to the financial scheme of the Second Five Year Plan, firstly because the second plan came out much after the study

was completed, and secondly (and perhaps more important) because the thinking behind its financial programme is not very different from what it was for the first plan. Also, since the reference to the plans is for illustrative rather than for descriptive purposes, the examination of the first plan should be enough. In the following chapter, an endeavour has been made to indicate, in broad outlines, the scope for the different capital taxes in India and the contribution that they may make in increasing the investible funds available to the government.

Since a start has recently been made in India in the field of capital taxation with the introduction of an estate duty I thought it would be useful to include in the present study a critique of the new duty. Unlike as originally planned, this critique of the estate duty evolved itself into proportions which could not be contained in one chapter. The entire Part III covers this. I must say that I am not unhappy in having to give all this space to the discussion of the estate duty because it has enabled me to examine the provisions of the law fairly thoroughly from an economist's point of view. In having done so, I may have served to fulfil a vacuum in recent economic literature on taxation. In the course of this detailed examination of the provisions of the Indian estate duty the experience gained in the sphere of death taxation in the United Kingdom and other countries, especially those in the British Commonwealth, has been frequently drawn upon for purposes of comparison.

PART I
THEORY OF
CAPITAL TAXATION

CHAPTER 1

THE DEFINITION OF A CAPITAL TAX

EVERY tax has a base. The existence of a base is an essential prerequisite to a government's demand on the citizens for the payment of a tax. The base may be anything like the ownership of a human head, the possession of land or cattle, or the number of windows in one's house. Every tax scheme relates quantities of payments required from the taxpayers to specified objective conditions. Thus a payment may be required of a taxpayer if he satisfies the condition of earning Rs X of income or payment may be asked for if he satisfies the condition of possessing Rs Y worth of capital. The payment in the first case could be described as an income tax and that in the second case being based on capital as a capital tax.

If we were fortunate enough to have an agreed definition of capital it would be possible for us to proceed straight on to the discussion of the economic implications of a capital tax. Unfortunately this is not so. It is essential for the purposes of our analysis therefore to attempt, in the first instance, a delimitation of the ramifications of this concept.

In spite of all the disagreements over the use of the term 'capital', most of the early economists seemed to hold that capital was a reserve, that it was capable of being productive, and that it was a provision for the future. They would consider as absurd the idea of including all wealth as capital and yet it was so difficult to draw a hard and fast line between wealth which was capital and wealth which was not. Adam Smith drew a distinction between the portion of stock which was held by the consumers for purposes of final consumption and the portion which was held by the producers, traders and dealers. It was the latter portion which Adam Smith regarded as capital because only 'that part (of a man's stock) which he expects to afford him this revenue' deserved to be called his capital.¹ But it is very doubtful if such a distinction as this is logically tenable. According to Adam Smith, capital in order to be productive should produce revenue. A cooking stove in a bakery yields revenue in that it bakes the

¹ *Wealth of Nations*, Book II, Chapter I, p. 221.

bread which is sold out in the market in return for money. But so does a cooking stove in the house because it bakes the bread for domestic use and yields satisfactions which would otherwise have been paid for in money.

This criterion of productiveness put forward by Adam Smith set the vogue for those who came after him. The modern association of productiveness with capital is very well embodied in the oft-repeated phrase 'land, labour, and capital' used in order to express the requisites of production. As students of economics we are so much accustomed to this view of capital that the mere mention of the word 'capital' brings the image of an instrument or a tool to mind. Marshall was fully conscious of the logical fallacy of distinguishing between different items of stock on the basis of productiveness, if productiveness were to be understood in terms of yielding satisfactions. He steadily grew in the conviction that there was something artificial in every broad distinction between capital in general and other forms of wealth. But in spite of his dissatisfaction with the existing definitions he was unable to put forward a determinate point of view. He was content with saying that 'there is no rigid definition which is universally available.' Something, he said, must be left for explanation by the context.¹

While it was generally agreed that capital was a stock or reserve of goods existing at any time, there was a difference of opinion as to whether the term could be used to embrace the entire stock of goods or only a portion of it. Irving Fisher was perhaps the foremost of economists to give up the distinction drawn between different parts of stock on the basis of productiveness and to assert that the term 'capital' should be so defined as to include *the stock of goods of all kinds, including land existing and owned at a given moment*. It is this definition that we propose to adopt for the purposes of this study.

Fisher's concept of capital includes, to use Adam Smith's words, both 'the part which he (the owner) expects is to afford him revenue' and 'the part which supplies his immediate consumption.' It does not distinguish between goods of the 'first order' and goods of the 'higher order' or between wealth for present use and wealth for future use. Strictly speaking, all wealth is for future use. 'The present is but an instant of time and all use of wealth requires some duration of time.'² As Fisher

¹ *Principles of Economics* (1895 Edn.), p. 152.

² Irving Fisher, *Nature of Capital and Value* (1927), p. 57.

points out, even the food laid out on one's table is for future use though the future is but the next few seconds. If by 'future' we mean to exclude the 'immediate future', it is difficult to say where the line should be drawn.

As regards the inclusion of land in this definition of capital, there is a good deal of argument for excluding it because, unlike the other goods, land consists of gifts of Nature whose supply cannot be increased by man. But is it not the function rather than the origin which matters when we think in terms of satisfactions? True, that for some purposes of analysis it may be desirable to distinguish between capital which is original and capital which is man-made or between capital which is permanent and capital which is non-permanent.¹ But it seems to us erroneous to exclude land or any other permanent thing from our term 'capital' just because it is given by Nature or because it has acquired some indestructible properties of yielding exchangeable human satisfactions. We are rather inclined to support Turgot's observation: 'Every landed estate is the equivalent of a capital; consequently every proprietor is a capitalist.'²

What would constitute the capital of an individual or a firm consistent with the above definition of the general concept? From our point of view, it is this concept of *individual* capital that is really important. At any moment of time an individual in a modern society possesses not only a stock of concrete goods but also a stock of intangibles in the form of bonds, shares, and mortgages. These intangibles are instruments through which the ownership of huge aggregates of capital wealth is parcelled out in small fractions. To an individual these rights in capital wealth are as much of the nature of assets as goods in one's personal possession. There might also be certain claims outstanding against the same person. If we treat these claims as negative capital the sum of the value of the total stock of goods and intangibles less the value of claims outstanding against the individual would give us his net capital wealth. As regards money, it is either in the form of a physical good like gold or silver or in the form of intangibles like notes and bank deposits. That part of money which carries value as a good is obviously to be treated as part of capital. The part comprising intangibles should also be treated as constituting the possessor's capital because these

¹ F. A. Hayek, *The Pure Theory of Capital* (1941), p. 51.

² *The Formation and Distribution of Riches* (Ashley's translation), pp. 50 and 91.

intangibles represent the debt owed by the State or the banking system to him. And, just as a debt owed by one person to another will cancel out when the assets and liabilities of the two are aggregated, so also will the debt owed by the State or the banking system cancel out when the capital of the entire community is calculated, and the total reduces itself to a collection of physical goods.¹

Our individual's capital would, therefore, consist broadly of the stock, at any moment, of:—

- (i) physical goods including land and buildings whether held for consumption or for use in production;
- (ii) securities including government bonds; and
- (iii) money.

The definition of capital adopted by us accords well with the usage of the term in business accounts. It is no doubt true that capital is variously talked of in different contexts but when it comes to the question of appraising the relative positions of different business concerns the term is usually understood to cover the total net assets. It is in this sense again that an individual would appraise his own position whether in absolute terms or in relative terms of comparison with others.

A CAPITAL TAX DEFINED

Having defined the term 'capital' it should be possible to say that just as beer tax is a tax assessed on beer, horse tax is a tax assessed on horses and income tax is a tax assessed on income, so is capital tax a tax assessed on capital. Unfortunately, the confusion which beset the use of the term 'capital' in the past did not make it easy for such a clear-cut meaning to be given to capital tax.

We have, for our purposes, defined a capital tax as a tax assessed on capital. It appears to be extraneous to terminological considerations whether the tax is paid out of capital or some other source. To assert that the tax on capital must be one which is necessarily paid out of capital springs from a failure to distinguish between the object of assessment and source of tax payment.² The distinction is generally recognised in the case of commodity

¹ This is what Prof. J. R. Hicks describes as 'capital of the community'. Our definition of capital for the individual is covered by what he calls capital in its business sense. *The Social Framework* (1952), p. 35.

² Gustav Cohn, *Science of Finance* (English Edn., University of Chicago, 1895), p. 354.

taxes. 'Nobody maintains that a tax assessed on beer is necessarily paid out of beer or even out of resources which would otherwise have become beer.'¹ The position is essentially the same in the case of a capital tax. The mere fact that a tax is assessed upon one or the other of the objects tells one nothing about its source; that is a wider problem involving question of incidence and the whole range of other economic effects of a tax (which we are discussing in the subsequent chapters dealing with the economics of capital taxation), and therefore should not be allowed to blur our conceptual approach.

In her evidence before the Royal Commission on the Taxation of Profits and Income, Mrs U. K. Hicks says that for a tax to be a capital tax, it should satisfy two criteria, one that it should be of such a large amount that it cannot be paid out of income, and two, that is is unexpected.² Mrs Hicks seems to take up the classical position of regarding a capital tax as one which is paid out of capital. For the criteria set down by her are clearly intended to locate capital as the source of tax-payment. Our difference with Mrs Hicks is one of approach. It does not appear to us necessary to set for our definition of a capital tax desiderata different in principle from those adopted in general for other taxes. However, to say this is certainly not to detract from the significance of the questions regarding tax-source. But it may be added that there are criteria other than those suggested by Mrs Hicks which seem to be more helpful in locating the incidence of a tax as between income and capital.³ The most important consideration in this respect is, as will become clear in our discussion in the following chapters, one of recurrence (or non-recurrence) of a tax-liability.

¹ A. C. Pigou, *A Study in Public Finance* (1947), p. 140.

² *Minutes of Evidence* (1954), p. 180.

³ It is, no doubt, true that a taxpayer would be inclined to meet his tax-liability out of his capital were it to cut into what he regards as his minimum consumption needs and in that sense the magnitude of a tax-liability is significant. But, a taxpayer may want to meet his liability out of capital even if the tax is not of a large amount. As regards the condition about the unexpectedness of the tax, it may be pertinently asked if not every new tax is unexpected. Perhaps not. In the course of her evidence, Mrs Hicks also confines herself to taxes with capital as their base. In fact, she devotes a good part of her memorandum to the examination of a form of capital taxation (i.e. the annual capital tax) which would not satisfy either of her conditions, once it ceases to be a new tax.

CHAPTER 2

THE GENERAL NATURE OF A CAPITAL TAX

IT is important to note that a capital tax, as conceived by us, is a general tax. That is, it does not seek to differentiate between the various constituents of capital charged to tax. This generality of the tax-base is a characteristic it has in common with other taxes like a general income tax or a general expenditure tax where the liability of the taxpayer is determined with reference to the aggregate value of a specific aspect of the taxpayer's economic behaviour whether as an accumulator of capital, or as an income earner, or as a spender. Since a capital tax is assessed on the whole corpus of the taxpayer's capital and does not differentiate between the constituent parts of his capital, the tax does not, by definition, offer any incentive for the diversion of resources from one type of asset to another. The occasion for avoiding the tax arises only when it is possible to hold one's assets in a form which does not attract the tax or attracts the liability partially. *A priori*, the generality of the tax precludes the existence of this possibility. In actual practice, however, it will depend upon how far it is administratively feasible to ensure that every asset, in whatever form, is taken into account in fixing the tax-liability.

DIFFERENTIATION OF A SPECIAL TYPE

There is, however, one sense in which a capital tax may be said to differentiate, and therefore to cause re-allocation of resources among the different types of assets. The possibility presents itself very clearly in the case of intangibles.¹ A 3 per cent gilt-edged may be worth at par the same as a 6 per cent industrial equity. Now, the 3 per cent on the gilt-edged may be taken as pure interest while the extra 3 per cent may be said to represent risk, length of maturity, and a variety of other considerations. An income tax of, say, 10 per cent will affect the two bonds equally and will cause no change in the relative earnings of the two. But

¹ This argument brings out the differentiation implicit in an annual tax on capital, but it could be applied also to other capital taxes viz., capital levy, and death duties. The argument could be developed in their case in terms of equivalent annual liability.

a capital tax of, say, one per cent (on the capital value) per annum will cause the return on the 3 per cent gilt-edged to fall to 2 and on the 6 per cent equity to 5. This necessarily impairs their relative positions, and the result will be that if the 6 per cent equity still sells at par the capital value of the 3 per cent bond will fall to four-fifths of the par value. The holder of the latter would thus suffer from an unintended capital loss because of the capitalization of the relatively disadvantageous position in which the new tax on capital places him as compared to the other investor.¹

In arguing that the capital tax upsets the equilibrium between different types of investments, it is assumed that the risk element in the return on the 6 per cent security is a function of its position relative to other investments. It might, on the other hand, be argued that the risk element is fixed in absolute terms taking into account the character of a particular investment, and that so long as the pure interest element remains the same in the case of various investments, their par values would remain undisturbed, notwithstanding the imposition of the capital tax. In other words, both the 3 per cent bond and the 6 per cent security, in our above example, would continue to be quoted at par even after the tax has come into force. According to this argument, the relation of the security prices at any moment, given no change in the pure interest element in the rate of return, would be a function of the relative risk-carrying positions of the investments in question and not of the overall income yields. If the investment represented by our 6 per cent security becomes less risky and therefore more secure and the market valuation of the remaining risk involved in this type of investment is put at 2 per cent instead of the earlier 3 per cent, the price of the security should rise by one third of its former price. Under the new equilibrium, the price ratio between the two investments would move from the parity position to that of 3:4.²

¹ E. R. A. Seligman, 'The Effects of Taxation', *Political Science Quarterly*, March 1923 (reproduced in *Readings in Public Finance and Taxation* edited by M/s. Mills and Starr, 1932).

² In algebraic terms, the arguments could be summed up as under:—

Let us represent the total rate of return on an investment by the symbol 'R', pure interest element by 'r', risk element by 'r2', market rate of interest by 'i' and market price of a security by 'V'. Now 'R' equals, in both cases, the sum of $r1+r2$. (Continued overleaf).

While it is hard to repudiate the latter argument completely, it does seem to ignore a number of points. The rate of return sufficient to cover risk is reckoned not only in terms of the relative risks of various investments but also in terms of the investment which carries no risk. Any calculation of the return adequate to cover risk would have to be very subjective because the values assigned at any time to probabilities of loss and gain would be conditioned by the prevailing business climate. Since the costs of risk are not susceptible of measurement in strictly objective terms, the calculations of the risk element of the rate of return have to, and do usually, proceed with reference to a certain base, and this base is no other than the rate of return over the safest investment yielding only the pure interest. Hence in common experience the first formula is found to be the one generally applicable.

Besides, the prices of securities are not determined only with reference to the rates of return as related to the cost of risk. One has also to take into account, on the demand side of the equation for security prices, the asset-preferences of the community. The capital wealth of a community, at any moment, is distributed over a number of different assets according to the relevant schedule of asset-preferences. If the asset-preferences, at any time, happen to be completely interest-inelastic, there might be little change in the existing security prices as a consequence of the imposition of a capital tax, even though the price fixation follows our more generally applicable formula. This would be so because people are not willing to vary their asset holdings in spite of the fact that the capital tax upsets the ratio of their income yields. But if this very unrealistic assumption of a completely

According to the first argument (para. 2) the price of a security will be determined as under:

$$V = R \frac{1}{(i + r_2)} \dots\dots\dots(1)$$

whereas the second argument (para. 3) would determine it according to the formula:

$$V = (R - r_2) \frac{1}{i} \dots\dots\dots(2)$$

In the second formula r_2 , being regarded as an absolute sum representing the cost of risk, is regarded as the first charge to be taken into account in the stock market appraisals.

interest-inelastic asset-preference schedule is dropped it would be justifiable to expect changes in security prices in the wake of the introduction of a capital tax.

THE MERIT OF DIFFERENTIATION

It has therefore to be conceded that capital taxation is not completely non-differential as between various assets. But this differentiation is regarded in many quarters as a distinct advantage of a tax on capital compared to a tax assessed on income. A speculative enterprise, if it is to attract capital, must offer a return over and above the gilt-edged rate of interest such as to provide an adequate premium to cover the risks involved in that business. An income tax relates liability to current earnings. Therefore, it cuts not only into the pure interest-income from investment but also into the element of income which compensates for the risks involved. Assuming that the liquidity preference curve is the same for pure interest net and gross of tax (an assumption which, it must be conceded, is highly arguable), the extent to which the reward for risk is reduced will affect the entrepreneur's willingness to invest capital and to undertake risk.¹ A tax on capital, on the other hand, does not impinge on the reward for risk. We have already observed that for purposes of capital valuation usually an adequate allowance is made for the return on risk involved. The 6 per cent equity sells on par with the 3 per cent bond because in the case of the former a deduction is made of 3 per cent as reward for the risk carried. Since a capital tax is assessed on capital value and not on income, the tax liability incurred is the same in respect of both the securities. This would not be so if the liability to tax were to be determined with reference to income. This means that under a capital tax the liability to tax falls on the pure interest element of income. Therefore, the lower the proportion of this element in total income, the lower the tax-liability. To put it the other way, a capital tax falls on investments with a severity which varies inversely with their riskiness and security. Although the Colwyn Committee on National Debt and Taxation (1926) did not ultimately recommend the imposition of a capital tax in Britain, it conceded the point made

¹ Professor J. R. Hicks explains at length how a highly progressive tax on income may cut into the investor's return on his capital to such an extent that the premium element is no longer sufficient to cover his risk. *Taxation of War Wealth* (1941), pp. 192 and 207.

above and agreed that a capital tax would give a stimulus to investment in the more risky class of enterprises 'inasmuch as £100 yielding £10 would only pay the same capital tax as £100 yielding £5 income.'¹

¹ *Report*, para. 899, p. 304.

In Holland, where a separate general tax on capital was introduced as early as in 1892, this discrimination in favour of risky investments was justified on the ground that the 'poor men, who could not afford to make much choice, generally preferred securities with higher rates of interest.' To tax income instead of capital, it was argued, would thus be to favour the rich man. How far the conditions then existing in Holland justified this assertion is not certain. But as things are today, the capital tax, on this reasoning, would be a discrimination in favour of the rich because they alone can afford to, and do dare to, enter venturesome enterprises.

CHAPTER 3

ECONOMICS OF THE CAPITAL TAXES

IN most discussions on capital taxes a distinction is drawn between taxes which are paid out of capital and taxes which are paid out of income. Quite often, this distinction gets involved into the other distinction based on tax-object. It has already been argued by us that for purposes of definition taxes which treat capital as their tax-base are to be considered as capital taxes. But this definitional approach does not reduce the importance of the questions which seek to go behind the tax-base in order to discover the tax-source. As for the tax-source, it may be said to have two aspects: distributional, and 'economic'.¹ There is, on the one side, the way in which the liability to a tax is distributed among persons in different economic positions, and on the other side, the effect that the tax produces on the decisions of the taxpayers concerning their economic conduct. It is intended to refer to the distributional aspect of the tax-source only indirectly as and when suitable occasion arises. For most of our discussion, we treat the re-distribution effected through taxation as a part of our given premises. This exclusion of the distributional aspect follows our intention to restrict this study to the consideration of capital taxes as a source of finance for economic development. The consideration of the economic effects of capital taxes is, on the other hand, an essential prerequisite to our being able to pronounce upon their suitability or otherwise as tools of development finance. In this and the following chapters therefore, we examine the ways in which capital taxes repercuss on economic behaviour. The present chapter deals with the broad effects of all the capital taxes, and in the next chapter the detailed implication in regard to each of the capital taxes is taken up for examination.

This chapter has been divided into three parts. First, we deal with the static position where total capital and total income remain unchanged and where differences in individual reactions

¹ The term 'economic' has been preferred to Professor Pigou's term 'announcement' because the latter has come to be associated with tax-effects under partial equilibrium, and is likely to mislead in our general equilibrium approach.

to various tax-proposals are ignored. Second, we delve into the dynamic aspects of tax-payment and examine the impact of individual reactions on economic aggregates. In the third and final part, the dynamic discourse is taken a step further and capital taxes are appraised as tools of functional finance.

DEFINITIONS

It will be helpful to indicate, in advance, the precise meanings attached by us to the important terms used in the following discussion.

Capital: It follows from what has been said in the first chapter that capital stands for stock. But an *individual's capital* consists not only of the stock of goods, but also of securities (including bonds, notes and bank deposits). It has already been noticed¹ that capital, in this sense, of the different constituents of an economy adds up to the *community's capital* consisting only of the stock of goods including land.

Investment: This is defined as the addition to the stock of goods during a given period. On the individual plane, a distinction is drawn between addition to one's stock of goods and addition to one's capital. One may, of course, both increase one's stock of goods as also one's capital but it need not necessarily be so. Hence, the distinction between investment and addition to capital on the *individual* plane. But, on the *community* plane investment and addition to capital are, by definition, equal.

IMPACT OF CAPITAL TAXES—STATIC POSITION

Taxes may be levied with reference to specific objects like land, house, car etc., or they may be imposed generally² on capital or income. But the source out of which the liability for any tax, whatever its base, will be met is either the community's current output or its stock of goods. These two together constitute the aggregate of resources available to the community over a given period.³ Now in a community without the State (i.e. ignoring temporarily the financial interference of the government) a large part of current output is used for purposes of consumption

¹ Chapter 1, *supra*, p. 9.

² In the sense that all objects are covered by either of the two terms, 'capital' and 'income'.

³ Following the analogy so effectively employed by Professor A. P. Lerner (*Economics of Employment* (1951), Appendix to Chapter 4 we may liken

and for maintaining intact the existing stock of goods. The balance, if any, is devoted to the increase of the stock to be carried over to the subsequent period. It is possible that no balance is left over in excess of what is used for consumption and maintenance, or even that the current output is not enough to cover these requirements and the stock of goods may be drawn upon.¹

Now, when the State comes into being, the community must meet its expenses out of the available resources. It may do so either by reducing its erstwhile consumption expenditure or by curtailing its outlay on maintenance and/or the new accretion to stock of goods. In case the community decides to reduce only its consumption expenditure, the resource thus made available would be used to finance the State's expenses. Such a course would not entail any reduction in the community's capital, existing or potential. But if the existing consumption expenditure does not admit of any reduction, the impact of the State's requirements shall fall on the community's capital.²

Thus far, the possible ways in which the demands of the State on the community's resources can be met have been noted. Now follows the question: How far can the community spare its resources for use by the State? On the consumption side, the maximum that the community can do is to cut down its

our aggregate to a pool of running water. There is a certain quantity 'X' which is standing in the pool and a certain quantity 'Y' which flows into the pool over a period, say, a year. Now, one may say that over a year 'X' plus 'Y' is the total quantity which will be available for outflow from the pool.

¹ Thus, in any one year, one of the following three things will happen.

Let us represent current gross produce by the symbol 'Y', capital (i.e. community's stock of goods) at the beginning of the year by 'K1', capital at the close of the year by 'K2' current consumption by 'C', capital maintenance costs by 'I1' and new capital (i.e. net investment) by 'I2'.

(a) Where the community makes a net addition to capital:

$$K2 > K1 \text{ and } K2 - K1 = I2$$

$$\therefore Y = C + I1 + I2.$$

(b) Where the community just manages to keep its capital intact:

$$K2 = K1 \text{ and } K2 - K1 = I2 = 0$$

$$\therefore Y = C + I1.$$

(c) Where the community eats into its capital:

$$K1 > K2 \text{ and } K2 - K1 = -I2$$

$$\therefore Y = C + I1 - I2$$

$$\text{i.e. } C > Y - I1 \text{ (Consumption exceeds net income)}$$

² The argument is based on the assumption of 'full employment' in the community. The State's current expenditure therefore, only replaces outlay in other sectors of the economy.

requirements to a minimum subsistence level.¹ This releases resources, over and above the consumption minimum, to be utilized by the State for its own purposes. (This is precisely what happens in a country in times of war.) The extreme assumption that the community cuts down its consumption expenditure to this minimum in order to meet the requirements of the State is intended to indicate the outer limit up to which taxation can cut into consumption without affecting the capital stock of the community. In actual practice, the limit would perhaps be reached much earlier. As regards resources devoted to maintenance and investment (i.e. I1 and I2), the community can both stop making net additions to the existing capital (assuming that it was doing so before the State came into being) and also reduce its outlay on maintenance of capital. If it suffices for the State's needs that the community only diverts its resources which were formerly used for making net additions to capital, the community's sacrifice, in material terms, amounts to its being content with the existing living standard. Of course, a certain minimum increase in capital is necessary just to cope with the increase in population and, therefore, it would, perhaps, be more accurate to say that in forgoing to build up its capital altogether the community acquiesces in the lowering of its living standard. And, it does so to a still larger degree when even the existing capital is not adequately maintained. The reduction in existing capital reduces the productive capacity of the community and, therefore, its current produce. The diminution of current produce not accompanied by any reduction in the State's demands would increase the relative burden of the State on communal resources. This leads, in subsequent periods, to a still further depletion of capital and, in consequence, to a further fall in current output.

The forgoing analysis leads to the conclusion that the demands of the State constitute a part of the total demand and that the source of State revenue is to be found nowhere else than in that pool of resources from which the means of satisfying other wants is also drawn. In other words, the source of taxes (assuming that the State revenue is collected in the form of taxation), as of the means of satisfying other wants, is the current gross produce of the community. The current gross produce includes an element of capital — an element which represents not only the outlay which goes towards making good the capital consumption involved

¹ Whatever that may be; it is a variable, not a fixed absolute amount.

in the process of production (i.e. I_1) but also the outlay devoted to the construction of new capital. Where a tax impinges on present consumption, it is the current standard of living which suffers, and where the tax reduces the portion going to capital, it is the future standard that shall stand to suffer. (It is assumed that the expenditure by the State is incurred on items which do not enter into the usual calculations of a standard of living.)

Although we have seen that taxes cut into consumption and/or capital outlays, two important questions remain to be answered. They are: (a) Do only particular types of taxes reduce the community's outlay on capital? (b) What is the source of payment of a capital tax? In answer to the first question it may be said that it is not at all necessary for any particular tax to be paid out of any one source. And certainly, the tax-object is no indicator of the source of its payment.¹ In order that a tax be paid out of consumption, it has to be small enough to be met out of the margin which the community as a whole is prepared to forgo, however reluctantly, out of its total consumption outlay. Let us suppose that the community is already paying a certain amount 'T' to the State in the shape of income tax and that this is the maximum it is prepared to spare out of its outlay on consumption. Now, when the State's requirements expand by an amount ' ΔT '; a new tax is imposed for the purpose and this time it is assessed on individual taxpayers' capital. Since the community has already exhausted what it can or is willing to spare from its consumption outlay, the additional tax will be met by cutting down its outlay on capital. But, if the order of events were to be reversed so that it was the capital tax which was already in force and the tax on income came later on with the expansion of the State's requirements, it is not difficult to see that it is the income tax and not the capital tax which has called for a reduction in the community's outlay on capital.

IMPACT OF CAPITAL TAXES — DYNAMIC TREATMENT

So far, the argument has been carried on in terms not of the individual but of the community. While it is true that no two individuals take precisely similar decisions, it is equally true that

¹ 'Merely to know that a tax is assessed upon one or the other of the objects tells us nothing as to how far it is paid out of resources which would have been used as income i.e. chiefly for consumption, or out of resources which would have been wholly turned into new capital i.e. saving.' A. C. Pigou, *A Study in Public Finance* (1947), p. 140.

most of the individual reactions to a particular situation follow a common pattern, and it should be possible to say what, *ceteris paribus*, the general reaction would be to a given situation. To find out how the individuals generally react to the imposition of a tax in financing it out of their consumption or not, the fundamental criterion is not whether the tax is levied on income or capital but whether it is singular (i.e. a once-for-all impost) or recurrent.¹

In the case of a recurrent tax on capital the taxpayer is aware that it involves a liability which has to be discharged year in and year out. He must chart out his plan of meeting this recurring charge. Assuming a given level of his income, his spending on consumption out of his income and his saving (i.e. the accumulation to his capital wealth), he can meet his liability in two possible ways. He may either reduce his spending or cut down his saving. The argument in this study contends that the individual taxpayer is likely to incline more on the first course than on the second.

Why would the individual react to the imposition of a recurrent tax on capital in the particular way suggested above? The answer is plain and simple. He does so precisely for the same reason which makes him meet most of his income-tax liability by curtailing his spending on consumption. Any income-earner distributes his income between spending and saving in a given proportion. This proportion is determined by the complex of forces which influence his decision to spend or not to spend on current consumption. Suppose our individual taxpayer is earning a certain amount of income and he distributes it between spending and saving in the proportion of, say, 8:2. With the imposition of a new recurrent tax (which comes to 10 per cent of income—this is regardless of the base on which it is assessed) payable at periodic intervals, he must decide how to meet the liability. If he meets it entirely by a reduction either of his spending or of his saving, he would be upsetting the proportion between spending and saving. In the former case the proportion between spending and saving will be 7:2 and in the latter case 8:1. Apart from the fact that the very nature of a particular tax may influence the individual's decision to spend or not to spend, it is fairly justifiable to assume that a recurrent tax will be met in such

¹ N. Kaldor, 'The Income Burden of Capital Taxes', *Review of Economic Studies*, 1942.

a way that the proportion is not disturbed. That is, the tax liability will be divided between spending and saving in the proportion determined otherwise in regard to the distribution of income under the two heads. Since a far higher proportion of income of most individuals goes into consumption than in saving, it is fair to conclude that a very large part of the liability arising from a recurrent tax is met by curtailing spending. It could be argued however, that a regular tax on capital is not neutral in its influence on the individual's decision to spend and not to spend. There is much to be said in support of this view and we shall analyse it in some detail later in this study. It must however be conceded that in so far as a tax on capital is a regular one, be it assessed on income or capital or any other base, it will tend to be met as indicated above.

As regards a non-recurrent tax, the likelihood is that it would be met by the taxpayer out of his existing capital wealth. This is because he knows that the liability is being incurred only once. If he meets it by curtailing his current consumption expenditure (most once-for-all taxes are very heavy in magnitude and cannot be met in this fashion), he bears the entire burden at one time, say in one year. But he knows that he won't have to pay it the following year and the year after that. If it is possible for him to distribute the burden of the tax over a number of years instead of shouldering it in one year, surely he will welcome it. To meet the tax out of one's capital is one such method of spreading its burden over time. If the liability is met by a reduction in one's capital the result is that current consumption spending remains almost unaffected and future consumption spending is affected in the same proportion as the future income will be reduced because of less capital.

This tendency for spreading the tax-burden of a non-recurrent tax is strengthened by the people's general attitude towards the future—the preference given to present pleasures or satisfactions of given magnitude over future pleasures or satisfactions of equal magnitude¹—and as a result, the burden of a non-recurrent impost is likely to be spread somewhat unevenly over time with the present being made to bear the least in proportion.² There are also factors such as the magnitude of tax and

¹ A. C. Pigou, *op. cit.* p. 97.

² It might be contended as a counter-argument that the dissatisfaction to be had from giving up command over one's capital may to some extent offset this

the time allowed for its payment which may be said to reinforce the above trend.¹ The amount of tax to be paid may be far larger than what could possibly be met by cutting down one's current consumption within the time allowed for its payment. But, even when the non-recurrent tax is not very large and can be met easily by reducing his current outlay on consumption, the taxpayer would rather meet it by drawing down his capital because of the operation of the influences mentioned above. It appears to us, therefore, to be in the very nature of an irregular tax that it should impinge on the past accumulations of an individual whatever be the object assessed to tax. A recurrent tax assessed on capital is as likely to be met by an individual taxpayer by economising on his current consumption expenditure as a non-recurrent tax on income out of his capital.²

A DIGRESSION ON SAVINGS AND INVESTMENT

When an individual decides not to consume the whole of his current earnings, he lays by the residual and this increases his capital. It is important to note that an act of saving (i.e. forgoing consumption) on the part of an individual does not necessarily lead to the creation of new stock of goods. An act of saving, involving, as it does, the creation of ownership of assets, may only force some other individuals to transfer to him some of their existing assets. The act of saving, by itself, involves a curtailment of consumption and leads, therefore, to a fall in the existing demand for consumption goods. Left to itself, this will lead to a decline in aggregate demand and, therefore, in incomes of some individuals who may be forced to dis-save. The assets held by those who dis-save pass on in this process to those who save and there is therefore no creation of new stock of goods. In fact, the process

tendency to put a greater than proportionate burden on the future. Surely, in weighing the present satisfactions with the loss of satisfactions in the future, this factor would go against the former. In a sense, the sum of present satisfactions is smaller than what it would be if no loss of one's capital were involved.

¹ Max West, *Inheritance Tax* (1901), p.119.

² When Kaldor complains that in actual practice wartime increases in income taxes tend to be met out of current income he seems to overlook the fact that wartime increases in incomes may be as much of capital nature (for purpose of ex-ante calculations) as the increases in income taxes. To say this is not, however, intended to dismiss his explanation of this departure from theory in terms of a belief in the long duration of the war and therefore the new taxes and the tendency born out of long usage to treat all income taxes as a current charge. 'The Income Burden of Capital Taxes', *op. cit.*

set in motion by the act of saving does not stop at this initial transfer of assets from the dis-savers to savers. It sets in motion a chain reaction of decline in aggregate demand followed by decline in incomes.¹

The mere act of saving may not only not lead to the creation of new stock of goods, it may be actually inimical to it.² In order that a decision to save should lead to the creation of new stock of goods, it is essential that it should be matched by a decision to invest.³ When an individual decides not to spend a part of his earnings on current consumption, he is said to have saved. But to save is not to invest. Either he must take a separate decision to invest his savings or someone else should decide to make an investment of a corresponding amount. In the complicated money economy of today, the decision to invest is usually taken by persons other than savers. The incentives which operate in one case are very often not the same as in the other. The decision to invest depends on the prospective yield of investment compared to the current rate of interest but the decision to save is the outcome of a host of psychological forces operating in a given objective background.⁴ A man may, as Prof. J. E. Meade points out, decide to build a new machine without deciding to reduce his own consumption, for he can sell securities for money at the current rate of interest. So also, a man may decide to save without deciding to build a new machine; it may as well serve his purpose if he holds more of bonds or securities.⁵ Relatively few save in order to invest.

CAPITAL TAXES AND INVESTMENT

In any case, whether the investor has to borrow the funds for buying the machine or he buys it with his own savings, it is the prospect of the yield on new investment as related to the current rate of interest which determines his decision. How would a tax

¹ A. P. Lerner, *Economics of Employment* (1951), pp. 72 to 77 and 107 to 109. Also, E. F. Schumacher, 'Public Finance — its relation to full employment', in Oxford Institute of Statistics, *The Economics of Full Employment* (1945).

² J. M. Keynes, *General Theory of Employment, Interest and Money* (1936), pp. 136-7.

³ In the sense of creation of new stock of goods.

⁴ According to J. O. Stamp, it is wrong to regard the whole fund of accumulated savings as though it were homogeneous. 'It is in fact an aggregation of separate funds saved under entirely different motives, and answering quite differently to changes in economic conditions.' *Fundamental Principles of Taxation* (1927), p. 170.

⁵ J. E. Meade, *Economic Analysis and Policy* (1936), p. 245.

on capital influence this decision of the individual to invest? The net profitability of the venture remains unaffected by the capital tax for the simple reason that when the individual ventures his own funds into the enterprise he pays the same capital tax as he would even if he abstained from investment and kept his assets in other forms of capital. His own savings would, therefore, exercise little influence on his decision to invest. But would not an increase in savings as a whole reduce the rate of interest and, therefore, make the investment ventures more attractive? How far variations in savings do influence the rate of interest is a question which cannot be dealt with at length in this study. It would be proper to follow Prof. A. P. Lerner and assume that savings are neutral in their effect on the rate of interest. His analysis leads one to conclude that although investment is the main reason for borrowing and saving is the main source of lending, neither the opportunity to invest nor the readiness to save has much effect on the rate of interest.¹ And, if savings are really not so important a consideration in determining the investment decisions, there is hardly any reason why even in the case of taxes which are likely to impinge on the taxpayer's savings, either because his urge to save is weakened by the prospect of his having to pay a tax on what is laid by in savings or because he meets his tax liability out of his savings, we should apprehend an adverse reaction on the part of investors.²

A tax measure retards investment where the tax liability is made to vary with the reward of investment. A tax on income depresses the businessman's willingness to go further just because the tax payable increases with an increase in his profits.³ Anything which he does to secure a higher income carries with it the liability to a greater amount of tax. A capital tax, on the other hand, reckons tax liability not on the basis of the current earnings of the investor but on the basis of his capital accumulated in the past. An investor, as has been said above, need not necessarily accumulate in order to invest and he would not, therefore, be

¹ Cf. *Economics of Employment*, op. cit. pp. 109 and 10.

² M. Kalecki clinches the issue when he says that an 'increase of the rate of capital tax does not tend to lower the net profitability of investment (which covers the risk) or to raise the rate of interest.' 'A Theory of Commodity, Income and Capital Taxation', *Economic Journal*, September 1937.

³ Prof. J. R. Hicks argues very convincingly that high rates of income tax have a highly deterrent effect on enterprise and that they exercise a very depressing effect upon industry in general. *Taxation of War Wealth* (1941), p. 193.

obliged to take into account the liability for the payment of a capital tax while deciding upon a particular investment.

But will not the investor take the tax into account if he were to accumulate the earnings of his investment? Suppose an investor has already had enough income to meet his current consumption requirements, and that the entire profits out of his investment are therefore intended to be saved. Since this additional income will become part of his capital, the investor's tax liability is bound to increase in respect of this addition to capital. In a case like this it is but proper that the tax should be taken into account when the pros and cons of a new investment project are weighed. Still, there would remain an important difference between taxing a certain amount as income and taxing it as capital on a recurrent long-term basis. For, in the latter case, one retains possession of capital over a long time and this fact of possession carries with it the discretion to use one's capital in any way (including consuming it if one so desires). But this seems to be an extreme assumption. Usually, a fairly large proportion of income from investment would be intended for current consumption and to that extent the capital tax would not exercise a deleterious effect on investment activity. In addition, the fact that most of the investment in the organized sectors of an economy is undertaken by corporations not directly liable to pay capital taxes (if it is assumed that capital taxes are assessed only on individual capital) makes the connexion between investment and taxation of capital much more remote and indirect.

Now, a capital tax impinges on the incentive to invest only through the investor's awareness of the tax liability which he will incur if he were to lay by a part of his profits. It is this awareness of the tax liability which is a factor of crucial importance in differentiating one capital tax from the other. The less certain is the investor about the likelihood of tax payment, the less potent would the harmful effect be on the incentive to invest. The distinction between capital taxes on the basis of recurrence is useful in this context as well. The liability of a recurrent tax is certain to occur after regular and usually short intervals, though it varies with changes in one's capital. A non-recurrent tax, on the other hand, is usually introduced without prior warning and its liability is fixed once and for all (i.e. the tax liability cannot be modified by any subsequent changes in one's capital).¹ Since the

¹ In this respect a non-recurrent capital tax resembles a poll-tax, which

element of awareness is rather extinct in the case of a non-recurrent tax on capital, its adverse effect on investment incentive is likely to be negligible. But the recurrent tax does enter into one's calculations in so far as investment profits are meant to be accumulated. This deleterious effect of a recurrent capital tax may be offset to some measure by the favourable turn in the terms and conditions on which funds are made available for investment. This is possible because of the differentiation¹ exercised by a capital tax in favour of risky investments (and the benefits of this differentiation should, it is felt, be more obvious in the case of a regular tax than a tax which has to be paid once in a while).

Earlier in this chapter it was observed that a community could meet the expenses of the State by paring down the current outlay on consumption as long as there is a willingness to do so. And this would happen irrespective of whether the tax (or taxes) imposed for the purpose is (or are) assessed on capital, income or any more specific object. But the fact still remained that the community did not react similarly to different taxes. It has now been seen that these differences in reaction arise not so much because of the tax-base but because of the regularity (or, irregularity) of an impost. The importance of the tax-base lies in a different sphere—the sphere of incentives. It is in this latter context that it was found essential to draw a distinction between the incentive to save and the incentive to invest. The capital taxes may affect adversely the incentive to save but its adverse influence on the incentive to invest is likely to be rather insignificant. In a money economy, where resources freed from the production of consumption goods need not necessarily be employed in the production of investment goods, a tax might be known to have adverse influence on saving and still not lead to any decline in investment.² Investment, as has been indicated above, depends not on the availability of savings but on the profitability of an enterprise. Even under conditions of full employment, the decision of the investors is determined by their assessment of the profit potentialities of new ventures. Savings come in only

the taxpayer cannot simply escape by varying his capital subsequent to the imposition of such a tax.

¹ Chapter 2, *supra*, pp. 12-15.

² In fact it could be justifiably contended that in conditions of under-employment, a decline in savings is positively beneficial to the economy because it raises aggregate demand for consumption goods and consequently of investment goods and thus increases the opportunities for employment.

indirectly. If sufficient resources are not released from consumption, any increase in investment outlay will raise the aggregate demand relative to aggregate supply and thereby cause a rise in costs and prices which will affect the profit calculations adversely. Thus savings assume importance not so much because they increase the supply of funds for investment but because they reduce the strain on total demand for limited resources. In an economy where inflation has made much headway, the influence of a tax on savings is a really important consideration which can be ignored only at the economy's peril. And, capital taxes have to pass that test before qualifying for a clearance certificate. This brings us to the verge of the discussion that follows.

CAPITAL TAXES AND FUNCTIONAL FINANCE

As an instrument of functional finance, the importance of a tax lies in the effect it has on the people in influencing their spending behaviour i.e. in making them spend less.¹ It makes them spend less both because they have less money to spend and also because they are poorer in their possessions than they would be without a tax. The first effect of a tax may be called the 'income effect' and the second the 'wealth effect'. To the extent that a tax is paid by the taxpayers out of their capital, it affects spending through, what we call, the wealth effect.

RECURRENT CAPITAL TAXES

It has already been observed that a recurrent capital tax is usually paid out of current consumption expenditure. It is a merit of the recurrent capital tax that its effect on spending is more or less determinate, in regard both to timing and magnitude, and as a tool of functional finance it can be employed with a certain amount of assurance as to its probable effects. The tax does not, however, possess sufficient built-in flexibility. It is a distinct advantage of an income tax, especially one levied on a progressive scale, that its yield varies automatically with changes in incomes. When incomes are rising, the tax-proceeds go up, thereby exercising a check on buoyant spending. When incomes are falling, the tax-proceeds decline and the sag on spending is reduced. (Even with a proportionate tax on income, variations in tax yield will follow the changes in incomes. But, with a

¹ A. P. Lerner, *Economics of Control* (1944), p. 308 and *Economics of Employment* (1951), p. 131.

progressively rising tax schedule, the variations registered in tax yield would be more potent.) But the capital tax is reckoned in terms of capital values and capital values are not perfectly correlated with changes in income from capital. Capital values do not rise or fall immediately following, and to the same extent as, the rise or fall in incomes from capital. There is, as it were, a time-lag as well as a price-lag in this capital-income and capital-value adjustment.¹ The market value of a capital asset, in a particular year, will not fall to zero just because its income during that year has become nil. Thus, in that year, the taxpayer would have to pay a certain amount of tax, if it is assessed on income. The capital tax would, therefore, continue to depress spending even in bad times when there is urgent need for giving positive encouragement to spending. Likewise, in a period of boom and over-confidence, the capital values do not rise as fast as the incomes and consequently the tax-check on spending is not so effective as it should be.²

DEATH DUTIES — AN EXCEPTION

The forgoing conclusions regarding a recurrent capital tax would, however, be difficult to apply to death duties which are, by definition, of the nature of a recurrent tax assessed on capital. They are payable every time a property (i.e. individual capital) changes hands at the time of death. Also, since there is a fair amount of regularity in the number of deaths occurring every year in a community, it ensures a steady inflow of revenue to the government from death duties. But, to the taxpayer the liability for the payment of death duties comes as a sort of non-recurrent charge which is not going to be repeated until his death. (For purposes of functional finance, it is immaterial whether one regards the incidence of death duties as a charge on the accumulator of capital or on the inheritor. The fact remains that in either case, the liability is regarded as a capital charge. In the former case, the consumption expenditure is curtailed over a long time before death, and in the latter case, over a long time after

¹ There is a third lag also, and that is the lag in uniformity because all capital values do not react uniformly to changes in capital-incomes.

² The lags are aggravated by the usual delay that takes place in re-assessment of capital values for purposes of tax. Administrative difficulties involved in undertaking frequent assessment are regarded by some as almost unsurmountable. And, if re-assessments do not take place promptly, flexibility in yield from capital tax may be reduced still further.

death.) Death being so uncertain, and usually distant, the individual taxpayer's reactions to duties associated with it, are more akin to the reactions following a non-recurrent impost.

NON-RECURRENT CAPITAL TAXES

Whether capital values are high or low at the time of its imposition, a non-recurrent tax on capital does not exercise any significant effect on current spending. In other words, the income effect of a non-recurrent tax is likely to be very weak. The tax is most likely to be paid out of one's capital. In consequence of a reduction in one's wealth, there may follow a fall in one's spending. This is, what we have decided to call, the wealth effect of the tax. A non-recurrent tax on capital exercises a more powerful wealth effect than a regular recurrent tax because the latter does not tend to be met by reduction in one's wealth (i.e. possessions) but out of current consumption expenditure. The wealth effect of a tax is, by its very nature, spread over time. Through the wealth effect, a non-recurrent tax projects, as it were, its tentacles into the future. The duration and the magnitude of the wealth effect are not, however, easily determinable. They depend on the distribution of capital ownership in the community and the psychological reaction of the people affected by the tax to the reduction in their personal possessions. Where capital ownership is concentrated in the hands of a very small section of the community, small inroads on capital might not make much difference to the disposition of the current budgets of the taxpayers. Where, however, the tax takes away as much as, say, 60 to 80 per cent of the personal possessions, the private budget dispositions may be affected considerably. But it is also possible that changes in the budget dispositions of this class might comprise a not very significant fraction of the aggregate current demand, and might not, therefore, attract much attention. In a community with a more even distribution of capital ownership, the effect on aggregate current demand may, however, be much more marked.

In any case, the fact that the deflationary effects of a non-recurrent tax on capital spread themselves over a long period instead of being concentrated over the time when it is imposed and collected makes it less useful from the point of view of functional finance. In an economy on the down-turn, the depressing effects of an irregular tax imposed and collected during the boom, will rather accelerate the pace and accentuate the slack. Of course, in a situation where the economy is under the strain of

excessive demand for a considerable period, for instance, during a long-drawn war and for some time after it, such a tax-measure as this could be usefully adopted to administer, as it were, a continuing deterrent to private spending. But even in these circumstances, this tax measure would not, by itself, deliver the goods. It would still be necessary to adopt other measures, such as an annual tax on capital, which exercise a more direct restraint on current spending.

CONCLUSIONS

The discussion in this chapter regarding the broad economic implications of capital taxes may now be summed up as follows:—

(a) Capital taxes do not impinge upon individual capital or community's capital just because they are assessed on capital. They cut into individual capital because they are not expected to be repeated within a reasonably foreseeable future; they cut into the community's capital when they impinge on the incentive to invest.

(b) Even though some capital taxes do impinge on individual capital, this does not mean that they tend to reduce the investment activity in the community. On the whole, capital taxes are less directly related to the determinants of investment than is, for example, a general income tax. It would be incorrect to say, therefore, that capital taxes exercise a particularly deleterious effect on investment activity in the community.

(c) Capital taxes may, on the other hand, encourage investment, in so far as they serve as a substitute for income and profits taxes which hit the investor's prospects directly.

(d) Only those capital taxes which impinge directly on current consumption fulfil the basic requirement which functional finance imposes on a tax. Those which tend to be paid out of individual capital fail to reduce current consumption demand. Their effect on current aggregate demand is diffused over time and indeterminate. Even those capital taxes which do affect current consumption demand are not very useful as built-in stabilizers and could not be depended upon to act as automatic levers keeping the economy on an even keel.

CHAPTER 4

THE DIFFERENT CAPITAL TAXES

THEIR ECONOMIC EFFECTS AND OTHER PROBLEMS

IN defining a capital tax we have laid emphasis on its following two aspects: (1) that it is assessed on capital, and (2) that it is a general tax. Now, there are three different taxes which satisfy both of these conditions. They are:

- (i) An Annual Capital Tax
- (ii) A Capital Levy
- (iii) Death Duties.

An annual capital tax is a regular annual charge assessed on the basis of the capital worth of a taxpayer. A capital levy is, on the other hand, a once-for-all charge, though assessed like the annual capital tax on the capital worth of a taxpayer. Death duties are a regular tax also assessed on a taxpayer's capital worth. They are recurrent because they have to be paid each time an estate passes by inheritance. But their recurrence is, from the taxpayer's point of view, irregular because the interval between one payment and the other is so very uncertain. For is not death unpredictable? All the three taxes are general in nature because they are assessed with reference to the total capital worth of a taxpayer and not to any specific item out of a taxpayer's total capital.¹

In this chapter it is proposed to examine separately the economic implications of each of the above three taxes and also to refer to the main problems connected with their administration. We continue to adhere to the definition assigned in Chapter 2 to the terms, 'individual capital' and 'investment'.

AN ANNUAL CAPITAL TAX

Historically, capital as a tax-base is perhaps of older origin than income. But in the past hundred years or so of industrial advance in the world it was the income tax which came to be regarded

¹ We have excluded from our purview any tax which does not satisfy both the conditions. The capital gains tax is a case in point. It is a tax assessed on capital but it is not a general tax because it is assessed only on that part of capital which represents appreciation in its value.

as the mainstay of government finances and also the best measure of taxable capacity. Lately however, second thoughts have been expressed in regard to the adequacy of income as a measure of the ability to pay taxes. This awakening is due in part to the search for new sources of taxation with the expansion of the State's functions because the taxation of income has reached, in some countries at least, a maximum limit. In part however, it is due to a genuine realization that income alone is an incomplete measure of taxable capacity. That income is an index of the ability to pay taxes is not generally disputed. But it is just one such index. Persons without any income (in the restricted sense of the term) may also be able to shoulder the tax-burden if they are owners of property. Ownership of property represents command over economic resources as well as does the accrual of income. It is inequitable therefore to subject one to taxation and not the other.

The proposal for an annual tax on capital is aimed at rectifying the imbalance that exists today in regard to the tax-treatment of income and of capital as indices of economic power. An annual capital tax is charged on the basis of the net wealth of the individual. No distinction is made between the various forms of property comprising an individual's capital. The purpose is not to discriminate against any particular form in which capital is held but to subject to tax the economic power represented by the entire capital holding. In terms of equity an annual capital tax serves as a counterpoise to an income tax, because it gives recognition to the ownership of capital as representing ability to pay taxation distinct from income.

ANNUAL CAPITAL TAX AND INCOME EFFECT

An annual capital tax is, obviously, a recurrent impost. A taxpayer would, therefore, try to meet this charge by reducing as far as possible his current consumption expenditure. The question arises: In what proportion will the taxpayer divide his liability between his consumption expenditure and capital? The annual capital tax is usually light enough to be met out of one's current earnings. Therefore, when the taxpayer is confronted with this recurrent liability, he has to choose between cutting down his current expenditure (i.e. consumption) and his current saving. Ordinarily, any fall in current disposable income will reflect itself in a decline in both current expenditure and current saving. The proportion in which this decline is distributed follows the

ratio between the propensities to consume and to save at the margin. The distribution is the closest to this ratio in the case of a fall in disposable income caused by a recurrent tax which does not differentiate between consumption and saving. The annual capital tax is, however, not neutral between consumption and saving. The taxpayer is aware that every accretion to his capital would increase his liability to tax. Whatever the motives behind his decision to save, the annual capital tax, it must be admitted, weakens their force. This weakening of the incentive to save will have two important effects: (i) it will upset the existing functional relationship of consumption to disposable income (i.e. raise the propensity to consume); and (ii) the taxpayer's willingness to meet his liability out of his capital (in the sense that whatever is saved becomes a part of his capital) would be greater in the case of the annual capital tax than for a tax neutral between consumption and saving.¹ The outcome of the operation of the two effects is that the marginal propensity to consume (operative in a negative sense) may be smaller for a decrease in disposable income caused by the annual capital tax than for a decrease caused by a neutral recurrent tax. If 'bi' represents the marginal propensity to consume in the former case and 'bo' in the latter case, the income effect of the decline in consumption demand as a result of taxation would be:²

(1) for the annual capital tax:

$$\frac{T}{1 - b_i}$$

and

(2) for an equal yield neutral recurrent tax:

$$\frac{T}{1 - b_o}$$

Now, since $b_i < b_o$

$$\therefore \frac{T}{1 - b_i} < \frac{T}{1 - b_o}$$

In other words, the annual capital tax may be less contractionary in its income effect than a recurrent tax with an equivalent yield which is neutral between consumption and saving.

¹ The first effect operates on the overall decision; the second operates specifically in relation to the income forgone. Both the effects are crystallized in a rise in the marginal propensity to consume.

² Here we have ignored the income-creating effect of government expenditure on the assumption that it will be the same in both cases.

ANNUAL CAPITAL TAX AND INVESTMENT

A recurrent tax based on capital exercises a decidedly less deleterious effect on the incentive to invest than does a tax on income because:

(a) the capital tax does not discriminate against high-return, risk-carrying investments compared with those offering liquidity and security but low return as does a tax on income;¹ and

(b) the capital tax impinges on investment incentive only to the extent the income expected from investment is intended for accumulation, and not for current expenditure.²

The adverse effect on investment due to slackness in enthusiasm caused by the imposition of an annual capital tax would not be so significant as for a tax relating tax-payment directly to the amount of productive effort put in by the taxpayer. It is true that with the great majority of income-receivers the supply of effort is markedly income-inelastic and therefore a tax directly relating tax-liability and reward for effort may have little adverse effect on the supply of such effort.³ But this could hardly be said of the investing class. An overwhelming proportion of investment is undertaken by persons belonging to high-income groups. In their case the supply of effort (i.e. enterprise) is not income-inelastic,⁴ firstly because the intensity of demand over the entire range of current expenditure (including saving⁵) is not so strong as in the lower ranges of income, and secondly because the marginal rates of tax at the higher ranges are very high. In view of this, the substitution of leisure or inaction for enterprise comes within the range of consideration of the entrepreneurial class when it is subjected to a progressive tax on income or profits. Since the relationship between reward for enterprise and its taxation is not so direct in the case of an annual capital tax, there may be a good deal of justification for one to argue for the replacement of income tax by an annual capital tax at higher scales of income.⁶ This should reduce the temptation to forsake enterprise for leisure and inactivity.

¹ Chapter 2, *supra*, pp. 12-15.

² Chapter 3, *supra*, p. 27.

³ A. C. Pigou, *A Study of Public Finance* (1947), p. 69.

⁴ A. C. Pigou, *ibid.* p. 70: 'If the prize of success, should it be won, is subject to heavy taxation, enterprise is likely to be discouraged to a significant extent.'

⁵ Saving may be treated as current outlay for the satisfaction of desires in the future.

⁶ The Shoup Mission on Japanese Taxation did actually recommend a

TREATMENT OF CORPORATE CAPITAL

According to Prof. J. R. Hicks, 'it is very possible that a capital tax might have a less discouraging effect on enterprise than an income tax with an equivalent yield,' but 'the extent to which this happened would depend upon the way in which the tax was assessed.'¹ Prof. Hicks strikes this note of caution against proposals to subject firms to an annual tax on capital. Corporate property should be reached, he says, through a tax assessed on the value of securities held by individuals and not by a tax assessed on the corporate property itself. To tax both would be tantamount to double taxation, discriminating against corporate type of business. To tax the corporation and not the stockholders would give scope for the shifting of the burden on to the consumers of the corporation's product.² The burden of the tax in such a case would not be on those whom the State intends to tax. Moreover, such a tax would put at a definite comparative advantage firms engaged in commerce as compared to firms engaged in industry because the former need, in general, to hold lower stocks including funds relative to their total turnover than is usually the case with industrial concerns. To the extent that this discrimination operates there might ensue a shift in activities from industrial to commercial sectors of the economy.³ It is also a drawback of directly taxing corporate capital that it becomes difficult to make the tax progressive in the sense of taxing the richer people at a higher rate. 'This can be done systematically if the levy is imposed on individuals and solely on individuals.'⁴

KALECKI'S PROPOSAL AND VALUATION OF BUSINESS ASSETS

Mr Kalecki has advocated⁵ the imposition of an annual

reduction in the top rates of income tax. It was suggested that instead an annual tax on capital may be introduced. *Report* (1949), pp. 80-82.

¹ J. R. & U. K. Hicks and L. Rostas, *The Taxation of War Wealth* (1949), p. 206.

² There would be a tendency on the part of firms to treat the tax on their capital stock as an element of their fixed costs which they must, in the long run, cover in the prices charged to consumers on their products.

³ This distortion of the economy is of particular interest in any study of the role of taxation in an underdeveloped economy where, in any case, there is usually a marked tendency for investment funds to flow into commercial rather than industrial channels.

⁴ J. R. & U. K. Hicks and L. Rostas, *op. cit.* p. 185.

⁵ Oxford University Institute of Statistics, *Economics of Full Employment* (1945), pp. 44 and 45.

capital tax as a substitute for income tax at the stage where it exercises a distinct inhibitory effect on investment. In his scheme the tax is levied both on firms and persons. But he suggests that, to avoid double taxation of firms, shares and debentures should be excluded from the valuation of capital when individuals are assessed to this tax. *Prima facie*, it should matter little whether, in the assessment of the annual tax on capital, one excludes shares and debentures from individual capital and assesses tax on capital stock, or includes shares and debentures and keeps out of account the corporate capital stock. But in actual practice somewhat divergent results accrue from these two methods of tax assessment. The divergence arises primarily because the ownership of capital in companies cannot at all times be said to be represented adequately by the ownership of shares and debentures. Market valuations of these securities are not wholly based upon rational considerations and to the extent that other considerations, which are not relevant to the valuation of capital stock of companies, influence the market appraisal of the securities the two methods referred to above will yield discrepant results. Kalecki's scheme is an improvement in the sense that, under his method of tax assessment, the tax would cover the entire capital stock whether in individual or corporate ownership. But it is open to a serious practical objection—an objection which has considerably dogged all serious discussion of the taxation of capital—regarding the difficulties of valuation of the business assets of companies.

According to both Prof. Pigou¹ and Dr Dalton,² an important item of private property difficult to appraise for purposes of tax assessment would be business assets. But the magnitude of this difficulty does not scare either of them³ because, except for a small proportion of business held by private companies and partnerships and individual traders, the rest is held by joint-stock companies.⁴ The trading assets of these joint-stock companies have not to be priced separately under their scheme (to impose a once-for-all levy on capital) because they would be included

¹ 'A Special Levy to Discharge War Debt', *Economic Journal*, 1918.

² *The Capital Levy Explained* (1923), pp. 37-8.

³ To support the proposal for a levy on capital. Their views have been cited here in connexion with the annual tax on capital because the problem of valuation is more or less the same in both cases and what they said for a capital levy in this context is equally applicable to a capital tax.

⁴ Same as 'corporations', the term employed in earlier passages.

in the value of the shares and debentures of these companies. And so far as shares and debentures are concerned, Prof. Pigou does not envisage any serious difficulty regarding their valuation except, perhaps, in the case of 'those classes of securities which change hands so seldom that their quotations are more or less fictitious.'¹ Indeed, if a large proportion of private property were not susceptible of easy appraisal through stock exchanges a good deal of glamour in the scheme for taxation of capital would be lost. The task of general valuation by the State itself would perhaps be so prodigious and prove so irritating that any government would think many times before embarking upon it.

No doubt, Kalecki's method of tax assessment eliminates the error arising from the somewhat inadequate pricing by the stock exchange but it introduces alongside almost insuperable difficulties which come in the wake of the direct valuation of trading assets. A more practical solution would be to assess a capital tax on the basis of shares and debentures in so far as corporate capital is concerned and also to require the government to exercise greater and more effective powers of supervision (in so far as it is practicable) over stock-exchange operations so that the market quotations reflect more closely the real value of the securities. If in spite of the suggested supervision of stock exchange operations, the market valuations of securities do not represent, in precise terms, the value of corporate capital in the community, they would still be the nearest approach to it. One would concede to Kalecki the point that social accounting considerations argue in favour of his method because it could secure the necessary precision. But for purposes of taxation it is not so essential that the value of the private capital assessed to tax (i.e. the aggregate shown in taxation returns) should agree with what appears in social accounting tables.² What is really essential for purposes of taxation is that the process of valuation should leave the least possible room for tax-avoidance by means of re-embodiment of capital in forms different from those that would prevail in the absence of a capital tax, so that they might carry less assessable value and, therefore, less tax liability.

¹ Op. cit. *Economic Journal*, 1918.

² Because capital as a functional or statistical concept and capital as a tax concept may be related but need not be identical. Gerhard Colm makes a similar point in regard to income in *Studies in Income and Wealth*, Vol. I (New York, 1937), p. 183.

Normally it would be difficult to achieve an agreement between the two sets of figures, firstly because any capital tax would start with a certain minimum exemption limit, and secondly because no tax assessment could be so meticulous as to cover all the small household goods which should, theoretically speaking, be treated as capital but which are, from a practical angle, almost impossible to take into account. The best that a tax can hope to achieve is to be the least differential as between different forms of capital. Indeed, in most of the British discussions of taxation of capital it is usually taken for granted that any such tax would be confined to individual capital. Whether or not this attitude indicates an implicit faith in the reliability of stock exchange valuations of company prospects is a matter of individual judgement. But it does show that the ownership of capital embodied in companies is considered to be adequately represented by shares and debentures as quoted on the stock exchange. Implicit faith in the stock exchange valuation is not justified. But a more equitable basis of tax assessment can be found, not by discarding the stock exchange valuations but by making these valuations more dependable.

VALUATION OF OTHER ASSETS

The suggestion not to approach corporate capital directly makes valuation easier for that part of private capital which is represented by shares and debentures. As regards the rest of private assets, including trading assets of private unincorporated companies and individual traders, agricultural land, houses and household possessions, the difficulties of valuation would still remain. But they would not be so formidable in magnitude¹ as would be the case if the trading assets of incorporated companies were also to be directly valued. As it is, the task would be essentially similar in character to that regularly undertaken for purposes of death-duty assessment. Still, the British Committee on National Debt and Taxation (1926) found that the task of valuation involved in the introduction of an annual tax on capital in the British tax system would not be worth while.² Mrs Hicks also arrives at some such conclusion although she is prepared to concede that theoretically there is a case for a tax of this

¹ This is more true of an advanced economy like that of Britain where the corporate form of business organization holds sway.

² *Report*, para. 900. The Committee is also referred to in discussions on the subject as the 'Colwyn Committee'.

type. She is rather sceptical about the prospects of the initial valuation for an acceptable general capital tax. But once this initial valuation is completed, she hopes that the subsequent revaluation of property at regular and fairly frequent intervals should prove distinctly less formidable.¹

It is somewhat difficult to see why Mrs Hicks has persuaded herself to share the pessimism of the Colwyn Committee on the question of valuation. She agrees that the annual tax on capital should be assessed only on the individual. It is therefore the non-corporate property which should be the cause of the allegedly insuperable administrative difficulties. Already in Britain, the estate-duty assessments approach corporate capital through individual ownership of shares and debentures. For the rest of the capital assets techniques of valuation have been evolved by the Inland Board of Revenue and are being successfully applied. What is required in the case of a general tax on capital is the extension of those techniques to all properties falling within the range of the tax.² Elsewhere, both Mrs and Prof. Hicks, in concluding their analysis of the existing local rating system in Britain, have strongly advocated the centralization of valuation machinery as the device to end the prevailing chaos in local rating. They have also suggested that nationwide revaluation³ should be conducted at regular quinquennial intervals. And all this, on their reckoning, would not only be a practical proposition but also prove a great economy on financial grounds. If that is truly the case, would not the combination of valuation work at the central level for local rating, an annual capital tax and death duties secure a still greater economy and efficiency without vitiating the administrative feasibility of the proposal put forward for the reform of local rating?

¹ U.K. and J. R. Hicks and L. Rostas, *op. cit.* p. 292. Also Memorandum by Mrs U.K. Hicks to the Royal Commission on the Taxation of Profits and Income — *Minutes of Evidence* (1945), p. 171.

² This was conceded by the Board of Inland Revenue in its *Memorandum on Capital Levy* to the Colwyn Committee on National Debt and Taxation. Appx. XXII to the *Report*.

³ It would be useful to draw a distinction between 'valuation' and 'revaluation'. Valuation is much more expensive and time-consuming because it involves (a) listing and (b) first appraisal of assets. For revaluation no relisting is required provided the lists are being kept up to date, and appraisal work is easier because of the availability of values initially fixed.

A CAPITAL LEVY¹

According to Prof. Hicks, a capital levy should be of such a magnitude as to fall upon the capital (as contrasted with the income) of the taxpayer. By his definition an income tax at a rate of more than 20 shillings in the pound is a capital levy. 'But there are many sorts of capital taxes assessed upon capital but payable out of income, which are not.'² Prof. Hicks seems to emphasize the magnitude aspect of the capital levy so much that he is prepared to ignore the other desiderata which are theoretically, perhaps, more important. It has been stated previously that it is hard to base the classification of taxes on differences in incidence. It is as likely that an income tax be paid out of one's capital as that a tax assessed on capital be defrayed from one's current earnings. One need not go so far as to suggest the case of a tax on income at the rate of 20 shillings in the pound. The stage where a tax will be met out of capital will usually be reached much earlier, that is when the disposable income net of tax is not enough to cover what the taxpayer regards as his minimum consumption requirements. Would Prof. Hicks be prepared to regard such a tax as a capital levy? If one goes by the rigid criteria set by him elsewhere³ in terms of expectations for drawing a distinction between income and capital it is difficult to see if one could really regard even a completely confiscatory recurrent tax on income as a capital levy. Without going over the entire argument regarding the distinctions based on tax-base and tax-sources, it is proposed to adhere to the earlier decision that a capital tax is one that is assessed on capital. On that reasoning, a capital levy is one that is (i) assessed on capital and (ii) is a non-recurrent once-for-all impost.

A capital levy is thus a tax imposed once and for all on the capital base. It carries an implicit, and sometimes explicit, undertaking by the State that the measure is not going to be repeated. A good deal has been said on the question of a government guarantee against repetition and some interesting devices

¹ The capital levy has attracted some attention in India since Independence but its economic aspects have not so far received adequate consideration. A detailed examination of these aspects seems particularly called for in order to clarify the potential value of this type of impost under the present conditions, in India.

² *Taxation of War Wealth*, op. cit. p. 180.

³ *Values and Capital* (1939), p. 172.

have been suggested to make these guarantees effective.¹ The question of guarantee, however, is at bottom a political question. It is a question of general public confidence in the government that it would resort to an emergency measure like a capital levy only when the situation really demands it and not otherwise. For purposes of the discussion that follows, it is assumed that the public believes with the government that a capital levy, once imposed, is not going to be repeated in the foreseeable future.

The importance given to the magnitude aspect of a capital levy has, however, a certain amount of justification. It lies in the fact that an extraordinary measure like a capital levy is intended to cope with an extraordinary situation and will, quite naturally, be of an extraordinary magnitude. The levies which have been tried in various countries on the Continent² give sufficient evidence of the fact that they usually carry a heavy rate which makes it virtually impossible for the taxpayers to meet their obligations in full by economizing on their consumption. They are almost certainly obliged to sell off some part of their assets. But the magnitude of a tax alone is not the reason which induces people to reduce their assets rather than to curtail their consumption. The expectation that the tax is not payable a second time would incline people to spread its incidence over a period instead of undergoing all the privation at one time. This tendency towards the spreading of a non-recurrent burden would be at work irrespective of the magnitude of the levy.

CAPITAL LEVY AND EMERGENCY

Normally, a government covers its current financial commitments out of its regular revenue. It is only in an emergency when these commitments shoot up that resort is taken to emergency measures for raising funds. Now the purpose of all the measures taken in an emergency is to secure to the State maximum possible

¹ J. C. Stamp suggested that the levy receipt should contain an undertaking that the wealth covered by the levy was franked for a minimum of 25 years from any tax of a similar kind; *Studies in Current Problems in Finance and Government* (1924), p. 235. The main defect of a proposal like this is that the guarantee applies to wealth already accumulated. The mere existence of this guarantee would, on the other hand, be a constant reminder that the new wealth accumulated after the imposition of a capital levy might any day be made liable to such payment — a fear for which there might otherwise be no justification at all.

² An account of the capital levies imposed after World War I and at the beginning of World War II is contained in *Taxation of War Wealth* (1941) by J. R. Hicks and his associates.

resources from private hands in order that they can be employed to mitigate the emergency. A capital levy is one such measure. Its choice in preference to, or in conjunction with, other measures must be based on the consideration of relative merits and demerits. The other main devices for raising emergency funds are: (i) enhancement of recurrent taxes, (ii) borrowing and (iii) currency and credit inflation.

SPECIAL TAX MEASURES

Current taxation (i.e. enhancement of the rates of existing taxes or imposition of new taxes of the type already in force) is usually unable to collect all that the State requires for an emergency; borrowing leaves it too much to the goodwill and good sense of the contributors to bring the collections up to the optimum; and inflation is too dangerous to flirt with without proper caution. Hence, the scope for special measures of taxation. Special tax measures are of two types: (i) those assessed on a special base with reference to a particular period of accrual and (ii) those assessed on a general base. Measures like excess profits tax, excess income tax and war increment levy belong to the first category. The liability in their case is determined on the basis of the excess accrual, during a particular period, in the shape of profits, income or capital value. In the second category might be included measures like a capital levy and special contribution¹ in which cases the tax-base is either the entire capital or the general investment income of the taxpayer.

For measures of the first type, there is a strong social justification. To the extent that the function of mobilizing resources in an emergency is left to the interplay of the forces of demand and supply, there emerge special gains because of the exceptional situation. These special gains create new inequalities which are likely to rouse a sense of unfairness among the people. Even if it is recognized that any special measure taken to curtail these gains would damage economic incentives they might still be necessary as a means of fostering national unity and maintaining morale in an emergency. Similar justification could not be advanced for a capital levy or a special contribution. A person, for example, is subjected to a capital levy on the basis of his capital worth regardless of whether his ownership of capital arose out of a

¹ - The name given to the special levy imposed in Britain in 1949 on investment incomes.

steady process of accumulation or out of the fortuitous gains accruing in the emergency.

Special tax measures could be classified also on a different basis: (i) continuing taxes and (ii) once-for-all taxes. Taxes of the first type continue, say, from year to year for the duration of an emergency.¹ Taxes of the second type are imposed only once in an emergency. Under this classification a war increment levy would fall in the first category if it is a continuing tax on the increase in capital worth accruing from year to year. But if it is a once-for-all impost levied, say, after the emergency is over it belongs to the second category. Excess profits tax and excess income tax are obviously in the first, as are a capital levy and special contribution in the second category.

THEORETICAL IMPLICATIONS OF A CAPITAL LEVY

Theoretically speaking, a capital levy could be as drastic as to take away in tax the entire capital in private ownership. A 100 per cent levy on capital without any minimum exemption limit would do the job. But the entire proceeds of such a tax would not be available for financing an emergency. The problem of finance may be eased only to the extent to which the capital thus appropriated gives the State title to that portion of the current produce as may be ascribed to capital. It is quite likely that even the entire capital income may not be available for emergency purposes if the balance of the community income is not enough to cover the minimum current requirements of the community.

Whatever the magnitude of a capital levy, any taxpayer thinks in terms of disposing of his capital assets when he finds that his tax liability cuts too much into his current requirements. Assuming current earnings as given, the taxpayer has to decide how far he could, and also should, reduce his current consumption requirements in order to discharge his tax liability. This decision is objective as well as subjective. It is objective in so far as there is at any time a certain basic consumption standard² which has come to be regarded as an essential minimum and this must be fulfilled. And it is subjective in the sense that

¹ The special taxes are by their very nature non-recurrent. But even among them some stay longer than others. Hence, this distinction.

² In any community, at any time, there might not be one but a number of basic consumption standards applicable to different groups constituting the community.

consumption over and above this basic minimum varies according to individual reactions to a tax demand at different times.

How would the taxpayers react to the imposition of a capital levy? For a non-recurrent impost like a capital levy the general tendency will be to spread its incidence over as long a period as possible instead of lumping it on the year of impost. In other words, the taxpayers would discharge their liability in respect of a capital levy not by cutting down their current expenditure but by disposing of their capital assets. This means that payment made for a capital levy does not represent a draft on the current spending of the taxpayers, or that the aggregate effective demand remains unaltered in spite of the imposition of a capital levy. There may, however, be some decline in current demand under the influence of the fall in the capital worth of the taxpayers (that is, the wealth effect may operate to reduce current consumption demand to some extent). But it does not alter the fact that the direct impact of capital levy on aggregate effective demand is nil.

Now, a certain amount of transactions in capital transfers is always going on in the economy. These transactions are the normal means through which constant adjustment to changes in individual asset preferences takes place. It is quite likely that some transactions might be attributable to the 'oppression' of the tax burden in individual cases. But these tax-induced transactions in capital transfers normally constitute a not very significant proportion of the aggregate. It is only when a substantial tax like a capital levy comes into effect that the problem of tax-induced capital transfers assumes importance. Because of the objective necessity and the subjective inclination to meet the liability in respect of a capital levy through the realization of assets, the existing equilibrium relationship between the different types of assets is likely to be upset. The form of asset most easily realizable is cash and that is also usually the medium of tax-payment. (This is the normal practice unless a government specifically legislates for payment in other forms as well.) The demand for cash (and those other forms which the State has approved as means of tax-payment) relative to other assets rises and it will affect adversely the prices of other assets. There is a genuine fear that the effects of a capital levy might, on this account, be seriously detrimental to investment (by depressing equity values). The difficulty could be overcome if the State undertook to accept

all the non-cash assets offered in payment of the levy. But this would involve an enormous administrative problem of holding diverse forms of assets and of their subsequent disposal.¹

PAYMENT BY INSTALMENTS

It is a distinct merit of adopting the instalment method of payment for the capital levy that, while it retains the advantage of a non-recurring tax on capital in so far as the incentive to economic effort is concerned, it lends to the levy the character of a recurrent tax by providing for a spread of its incidence over a certain period. Besides, in magnitude the instalment would in all cases be much smaller than the corresponding total liability and the nearer it approaches the excess of a taxpayer's current receipts over his consumption expenditure, the greater are the chances that it would be paid by economizing on current consumption expenditure. But the instalment method can only be adopted in an emergency which is expected to last for the period over which the payment is going to be spread. In an emergency of a shorter duration lasting for, say, a year there would hardly be any idea of adopting the instalment method of payment. But in any one year the maximum resources that the State can have at its command could not exceed what is left over from the community's current receipts after meeting the minimum consumption needs of the people. However, if a capital levy is imposed with a view to collect this excess it is quite likely that because of the non-recurrent character of this impost the taxpayers would discharge the liability by dislodging some of their assets. They can, thereby, diffuse the burden of the levy, however small in magnitude, over time. Now, to the extent this levy

¹ There is no doubt that the work involved in holding non-cash assets of immensely diverse character and their subsequent disposal would put a tremendous strain on administration. The real justification for a general undertaking of this type could be sought not so much in the adverse effects of a 'cash' levy as in the socialist plea that it would pave the way for the socialization of property. G. D. H. Cole recommends this method for adoption in the case of death duties to achieve this socialist objective. 'Is this Socialism', *New Statesman and Nation Pamphlet*, 1954, p. 19. Also see Douglas Jay, *The Socialist Case* (1937), pp. 277-8. Another socialist argument in favour of the acceptance of non-cash assets, especially shares and debentures of companies, put forward by Mr. Evan Cooper Willis is that as more claims on the earnings of companies can be removed from private hands, the less can private property grow with the long-term secular rise in prices. *Towards Equality* (Fabian Pamphlet), 1953.

is met out of the sale proceeds of assets and not out of savings effected in current expenses, it fails in its primary objective of mopping up the maximum possible current resources. To that extent therefore, it secures only a transfer of capital assets whose contribution to the immediate needs of the emergency consists only in the capital income ascribed to them.

VALUATION AND ASSESSMENT

The difficulties involved in the valuation of individual capital¹ have been referred to earlier in this very chapter. For the annual capital tax, the most difficult problem is one of initial valuation when the tax is first introduced. Subsequent revaluations are not very involved. But in the case of a capital levy, there has to be only one valuation and if this one valuation happens to be the first one in a country, the task is undoubtedly difficult. We have already said on the authority of persons like Prof. Pigou and Dr Dalton that this task of first valuation, even though formidable is still within the reach of a government which already possesses a staff sufficiently trained in the valuation of properties for purposes of estate duty. What aggravates the difficulties in the case of valuation for a capital levy is the insistence, with some reason, on speedy assessment.

During the course of the controversy provoked in Great Britain by the capital levy proposal after World War I, it was suggested by Mr Sydney Arnold that valuation need not be completed before the collection of the levy is commenced. According to him, initial liability should be determined on the basis of the valuation returns submitted by the individual taxpayers. The government could subsequently go through all the valuations and check them and the amounts paid under the levy would, where necessary, be adjusted accordingly.² But, as was pointed out by Mr A. A. Mitchell, unless the preliminary valuation is to be made absolutely at random, the immediate assistance of experts is required by the individual taxpayers.³ To some extent therefore, Sydney Arnold's suggestion only shifts the onus of valuation from the State to the taxpayers and the problem created by the overall

¹ It is assumed that capital levy would be payable only by individuals and that corporate capital is represented through shares, debentures etc. held by individuals.

² 'A Capital Levy: The Problems of Realisation and Valuation', *Economic Journal*, 1918, p. 164.

³ 'A Levy on Capital', *Economic Journal*, 1918, p. 274.

shortage of expert valuers would still remain. However, to the extent to which such a proposal has the merit of spreading the task of valuation over time, it does redeem the position. The drawback of the suggestion is that it cannot be introduced in the event of a short-duration emergency when the proceeds of the levy are in immediate demand. It is also problematic to delay valuation when sufficient stability in the general level of prices is not assured and the taxpayers are, therefore, prone to understate the value of their capital holdings in the initial returns so as to defer the payment of the levy. However, under conditions when the public has no occasion to expect disturbing price movements and when the government is prepared to allow the payment of the levy to be spread over a period through instalments, Sydney Arnold's proposal has an empirical appeal. It combines with the merits of a capital levy payable in instalments, the advantages of a proper, though delayed, valuation. Needless to add that in a country where an annual capital tax is already in force, the inventory of individual capital would already exist. Therefore, the task of valuation for the purpose of a capital levy would be far more easy and assessment could be completed with much greater speed than where one has to start, as it were, from scratch.

DEATH DUTIES

Death duties are a form of tax which is difficult to put in either of the two categories—recurrent and non-recurrent. It is recurrent because it is linked to a recurrent phenomenon—death. It is non-recurrent because there is hardly any regularity in the periodicity of deaths. In different families the periodicity of deaths would be different at the same time and it would be different within one house at different times.¹

DEATH DUTIES AND CAPITAL LEVY

Death taxation is as much a tax on capital as a capital levy. In both cases it is the generality of one's property which forms the basis of tax. But while in the case of a capital levy all owners of property are subjected to it at one and the same time, in death taxation the liability to tax-payment arises with the occurrence of an extraneous physical phenomenon. Of course, the awareness

¹ The differences in periodicity referred to here are compatible with the regularity in the number of deaths referred to in Chapter 3, *supra*.

of the liability is always present in the latter case. Taking the age composition of a society at any moment, every member should expect to fall within the grasp of this tax eventually. The older members of course, would expect to confront it earlier than the younger ones.¹ The other point of similarity is the non-repetitive character of the two imposts. A capital levy is imposed once and for all and is not expected to re-appear except in the event of an emergency. Also a death tax is known to be payable only once in a generation because 'no man can die more than once.'² This point of similarity cannot, however, be taken too far. A capital levy is non-repetitive not only within a generation but also over generations in the sense that the emergency necessitating resort to it may not arise for a period covering a number of generations. A death duty, on the other hand, is payable by every generation and is, therefore, repetitive in that sense.

Having paid a capital levy once, the tax payer knows where he stands in regard to his personal capital assets. He takes decisions about his future course of action with the belief that a liability like this is not going to recur in the foreseeable future. For persons in the higher income scales, where a good proportion of income can be said to be devoted to the building up of personal fortunes, the faith in the non-recurrence of the levy could act as an important economic incentive. Suspicions about its recurrence weaken the incentives. In the case of death taxation, on the other hand, the fact of the tax liability is well known. The income-earner does have to reckon with this fact when he decides to earn in order to build up a fortune. The redeeming feature of this foreknowledge of the tax liability is that one knows for certain that it does not impinge upon the accumulation of a fortune during one's own lifetime. The taxpayer can have full benefit of his fortune so long as he is alive. It is only after his death that his fortune becomes the subject of taxation. The persons who really stand to suffer from this type of taxation therefore are not the accumulators of the fortune but those who inherit it. The latter receive by inheritance less than they would in the absence of death duties.

DEATH DUTIES AND INCENTIVES

The incentive effect of the prospects of death taxation

¹ The consensus of expectations would be based on the general trend in life expectation at various age levels.

² Gladstone quoted in C. F. Bastable's *Public Finance* (1903), p. 594.

is determined by the relative force which the interests of the inheritor exercise on the accumulation of the fortune. It is generally recognized that the desire to bequeath is not the only motive of fortune accumulation. There are a number of other motives which contribute to the desire to accumulate. 'All those motives are concerned only with the lifetime of the man who contemplates saving under the stress of them; the fact that after his death his fortune does not also die, is, so far as they are concerned, an irrelevant accident.'¹ As one goes up the ladder of property ownerships the part which the desire to bequeath plays in stimulating the accumulation of fortunes becomes weaker and weaker. Hence, the disincentive effect of death taxation on the income-earning activities of the persons in the higher property groups becomes smaller and smaller. A progressively rising death tax, which taxes the smaller property owners lightly and gets heavier and heavier on owners of large fortunes would, therefore, have less deleterious effects on incentives than a proportionate tax of the same size.² But a proportionate death tax is less damaging in effects on incentives than a similar impost of lump-sum character payable within one's lifetime on a foreseeable date in the future.³ This is because, in the case of the lump-sum impost all the motives underlying the desire to accumulate including the desire to bequeath would be adversely affected whereas in the case of a death tax only one of the motives receives a shock.

In terms of economic incentives, a death tax is preferable also to an equivalent annual tax on capital. All the motives which stimulate the accumulation of personal capital are adversely affected by an annual tax. Perhaps the disincentive effect of an annual capital tax is somewhat stronger than of a lump-sum tax on capital payable within one's lifetime because of the closeness in time of the tax liability. But the difference cannot be very

¹ A. C. Pigou, *A Study in Public Finance* (1947), p. 143.

² This justification for a progressive death tax is in terms of economic incentives and is tenable irrespective of whether or not one subscribes to the more popular arguments favouring progression based on the concept of diminishing marginal utility of income and wealth.

³ Such a lump-sum tax differs from a capital levy in the following respects: (i) it is not immediately payable and (ii) its basis of calculation would be the capital ownership as on the date it becomes payable and not as on the date when the impost is announced. The purpose of this comparison is to underline the argument that a liability which is to be discharged after one's death is less of a disincentive on economic effort than a liability which has to be discharged within one's own lifetime.

significant. In any rational calculation of the pros and cons of an economic action the impact of the lump-sum tax and of the equivalent¹ annual capital tax should be more or less the same.

FINANCING OF DEATH DUTIES

If one were to go by the considerations of incentives alone a capital levy is superior to a death tax and a death tax is better than an annual tax on capital. But a capital levy cannot by its very nature be a perennial source of revenue whereas death taxes are, for the same reason, unsuitable as an emergency means of finance. However, both the death taxes and the annual tax on capital are perennial sources of finance and the incentive desideratum gives the former a distinct advantage over the latter. But there is another consideration as well to be taken into account. The annual tax on capital would, like the income tax, tend to be paid largely through economies effected in current consumption expenditure both because of its lighter magnitude² and its recurrent character. The death taxes, on the other hand, will in all likelihood be paid by sale of assets rather than by economies in current consumption outlay.³ For an individual taxpayer the death duty, when it falls due, is usually too heavy to be paid out of his current earnings. Also, since it is not expected to recur till the lapse of another generation, the general tendency would be to spread its burden rather than concentrate it over a smaller period which might involve a drastic cut in current expenses. And again, as Prof. Pigou points out, the heirs to a fortune as a rule look to what actually comes to them by way of inheritance and are little interested in what would have come to them had there been no death taxation. They are, therefore,

¹ To achieve the equivalence in the above sense, we must satisfy the following equation:

$$\frac{\text{Lump-sum Tax}}{(1+R/100)^n} = \frac{\text{Annual Tax}}{(1+R/100)} + \frac{\text{Annual Tax}}{(1+R/100)^2} + \dots + \frac{\text{Annual Tax}}{(1+R/100)^n}$$

where 'R' is the rate of interest and 'n' is the period after which the lump-sum tax is due for payment.

² An annual tax on capital with yield equivalent to a death tax would naturally be lighter in rates because it is spread over the entire capital in private possession whereas the death tax is levied only on that part of this capital which becomes due for transfer on death.

³ This is an important consideration and it breaks down the superficial similarity between the two taxes. Mrs U. K. Hicks, it appears, ignores this consideration when she argues that death duties, because they are a regular part of the revenue, are, 'for the economy as a whole' the same in their effects as an annual capital tax. *Public Finance* (1948 reprint), p.237.

very unlikely to meet any part of a death duty by cutting down their current consumption.¹

DEATH DUTIES AND AGGREGATE DEMAND

The revenue from death duties like that from a capital levy represents in the main a transfer of assets from private to public hands. Assuming that the entire revenue is collected in the form of cash, death duties shall come mainly out of that part of the cash which is held in the private sector as a store of value. The payment of death duties amounts, therefore, to a transfer of some inactive cash from private hoards to State coffers. If as a result of the reduction in the amount of cash in private hands there is a rise in the rate of interest, this might have adverse repercussions on investment activity. But any tax collected in cash leads to a decline in the cash holdings of the private sector and this would, assuming no change in the transaction and stock demand for cash, lead to a rise in the rate of interest. In this respect, therefore, death duties are no different in effect from other taxes. What is important to note is that cash transferred to the government in payment of death duties does not represent a reduction in the private demand for current product. If, therefore, the government decides to utilize currently the cash thus acquired for the purchase of currently produced goods and services, the result would be a rise in the aggregate effective demand by almost the full amount of such an outlay. But this will be only the initial rise immediately following the State's decision to spend the proceeds of death duties. This initial rise in effective demand is likely to set in motion the Keynesian multiplier and lead to an ultimate increase of multiplier times the initial rise. In the following two paragraphs we propose to give the algebraic demonstration² of this very conclusion.

In algebraic terms our basic identity in regard to national income may be written as:

$$Y = C + I + G \dots \dots \dots (1)$$

We assume that:

$$C = b(Y - T) \dots \dots \dots (2)$$

and

$$G = T + D \dots \dots \dots (3)$$

¹ Op. cit. p. 140.

² Our treatment draws largely on Prof. T. Haavelmo's article on 'The Multiplier Effects of a Balanced Budget' in *Econometrica* of October 1945. But the result obtained by us may be said to modify the conclusion arrived at by him.

(In these equations, 'Y' stands for national income at factor prices, 'C' for consumption outlay of the private sector, 'I' for investment outlay of the private sector, 'G' for government outlay, 'b' for the propensity to consume, 'T' for tax revenue from sources other than death duties and 'D' for tax revenue from death duties)

Equation (1) is a basic identity. Equation (2) states that consumption is a function of income net of taxes other than death duties. Since death duties are not regarded by the taxpayers as a current charge for the sake of which they should forgo a part of their current consumption, it is assumed that 'C' is independent of 'D'. Equation (3) sets down the balanced budget condition equating total government outlay to total tax receipts. Now, by substitution, we can rewrite equation (1) as under:—

$$Y = b(Y - T) + I + T + D \dots\dots\dots(4)$$

$$\text{or } Y = \frac{I}{1-b} + \frac{D}{1-b} + T \dots\dots\dots(5)$$

Thus, any change in 'D', i.e. government outlay financed out of death duties will, assuming no change in 'I', 'T' and 'b', will cause $\frac{1}{1-b}$ times change in 'Y', i.e.

$$\Delta Y = \frac{\Delta D}{1-b} \dots\dots\dots(6)$$

We could extend our formulation to the case where a change in 'D' is matched by a corresponding inverse change in 'T'. This will happen when the government maintains its current expenditure on goods and services but substitutes death duties for other taxes as a source of revenue. The change in 'Y' will be:

$$\Delta Y = \frac{\Delta D}{1-b} - \Delta T \dots\dots\dots(7)$$

Since ΔD is assumed to equal in magnitude ΔT (ignoring the algebraic prefixes), we may rewrite the result as:

$$\Delta Y = \Delta D \left(\frac{1}{1-b} - 1 \right) \dots\dots\dots(8)$$

Within the premise of a flexible monetary and credit structure, the above treatment makes a number of simplifying assumptions. It is assumed that we are dealing with a closed economy, that tax proceeds other than death duties do not vary with changes in income, and that the government outlay is on

goods and services which are currently produced. The relaxation of these assumptions will require some modification of the results obtained in equation (6). But it must clearly be stated that these assumptions are not more fundamental to our argument than they may be to the consideration of the general income multiplier. It remains true that (a) government outlay financed out of death duties will be expansionary, and (b) the extent of expansion taking place as a consequence will be about multiplier times the outlay. But when account is taken of the leakages because of (i) the import content of the increased consumption outlays, (ii) the tax content of the increased incomes, and (iii) the import or saving content of the initial outlay, we may need to modify both the multiplier and the initial outlay. The first two leakages will affect the multiplier and the third will involve a subtraction from 'D' itself. Our equation (6) will stand modified as under:

$$\Delta Y = \frac{\Delta D - R}{1 - b(1 - t)}(1 - d) \dots\dots\dots (9)$$

(Where 'R' stands for the import or saving content of the initial outlay financed out of the new proceeds from death duties, 'd' stands for the marginal propensity to import, and 't' stands for the marginal propensity to tax).

This modified version follows, more or less, Ralph Turvey's exposition of the general income multiplier.¹ It is important to note that the leakages referred to above have to be accounted for in estimating the expansionary potential of any new outlay and are not specific to the outlay from proceeds out of death duties.

In multiplier analysis of the above type it is usually assumed that the independent variables other than the one whose change is the subject of investigation retain their value at the pre-change level. In our case, this means that we are ignoring the effects, if any, on 'I' (i.e. private investment outlay) of the announcement of the change in death duties, and on 'b' (i.e. marginal propensity to consume) because of either the disincentive to saving or any re-distribution in the ownership of capital. No doubt, for any marked change in death duties, these effects will have to be

¹ See 'Some Notes on Multiplier Theory', *American Economic Review*, June 1953. It is worth mentioning that Ralph Turvey makes an assumption (by intuition as it were) for purposes of illustration, that 'the income destroying coefficient' of death duties is zero, which is another way of saying that taxpayers do not cut down their current expenditure to meet death duties.

reckoned with. But for small changes one could perhaps assume that these effects are not very significant.¹

DEATH DUTIES AND AGGREGATE CAPITAL²

To say that death duties tend to be paid out of the taxpayer's existing assets rather than out of his current expenditure does not mean that they lead to a reduction in the sum-total of existing capital in the community. The existing assets will no doubt change hands but the aggregate of assets in the community (i.e. in private and public sectors combined) will remain unchanged. As regards the construction of new assets, the decisions to invest in the private sector lean heavily on the profitability of investment opportunities as related to the current rate of interest. Death duties influence these decisions by reacting on the profit expectations of the investors. They may, by putting some of the existing capital assets on the market, increase the supply of investment opportunities relative to current demand and thus do some damage to profit expectations. Or, they may exercise an adverse influence on general incentives of enterprise in so far as the awareness of death taxes enters into the calculation of the investors. It is therefore conceivable that death duties may to some extent retard the building up of new capital assets. But this effect of death duties has to be distinguished from the 'annihilation of capital' alleged to take place because the taxpayers are forced to part with their capital assets in payment of death duties.

It is sometimes suggested that the revenue from death duties should be earmarked by a government for investment. The suggestion is based on the argument that the receipts from death duties represent that part of the current earnings of the private sector as a whole which, but for this liability, would have been spent on investment. This argument is a logical extension of the plea very often put forward in defence of death duties against charges of capital annihilation referred to above. It is stated that since only a section of the community becomes liable to death duties at any one time, the capital assets sold by the taxpayers can very easily be bought by the rest of the community

¹ B.H. Higgins, in his 'A Note on Taxation and Inflation', *Canadian Journal of Economics and Political Science*, August 1953, deals with this aspect of Haavelmo's proposition in terms of taxation in general.

² The arguments developed in this sub-section can be applied, with proper modification, to the consideration of the impact of a capital levy on aggregate capital.

out of their current saving. If that is so, it follows that a part of the community's current savings are used up in buying existing assets instead of in building up new assets. Unfortunately, the logic behind this plea and therefore its extension is fallacious. Firstly, it is based on the classical assumption that all savings are automatically invested, which is not correct. Secondly, to say that the assets which are dislodged by one section of the community are bought over by the other section out of their current savings is not necessarily correct. For this latter section of the community, the transaction might be only of the nature of exchange of one type of assets for another. It is not inconceivable that the person buying the country villa of a decedent squire (on whose estate death duty is payable) may be paying for it not out of his current savings but out of the liquid balances that he happens to hold. It is also worth while remembering that so far as the private sector is concerned, any tax-payment, including that for death duties, involves a transfer of assets to the public sector. Since tax-payment has usually to be made in cash (and cash is one of the various assets held in the private sector¹), the taxpayer has to have the necessary amount of cash. To do so, he may have to get some of his non-cash assets changed into cash. This may be said to involve an exchange of illiquid or less liquid assets into liquid assets but it does not, by itself, mean an exchange between old assets and current savings. As regards the nature of payment made in respect of death duties we have already observed that it may not represent the withdrawal of current effective demand. It is therefore not correct to say that in the very process of paying death duties there occurs a withdrawal of current resources from investment.² However, as we have ourselves indicated earlier, death duties may retard investment to some extent because of the operation of adverse incentives. Also, the fact that as a result of the imposition of death duties more assets (of the type which if newly built comprise current investment) are on the market for sale may reduce the need or the incentive for building new assets and thus cause a reduction in current investment. Still, the earmarking of revenue from death duties for public investment is not the means to rectify even this setback to investment.

¹ Although it cancels out in the final summation of assets for the community as a whole (i.e. private and public sectors combined).

² It appears that Mrs U. K. Hicks subscribes to the view which we are criticizing. She says that 'if capital taxes are not accompanied by compensatory

In fact, there is every reason for a government to exercise caution in utilizing the proceeds from death duties for any current expenditure, be it on investment or not, because of its likely expansionary effects on the economy.

increase in real investment, they may lead to "capital consumption"—a deterioration in the community's provision for the future.' According to her, capital consumption 'will only happen if saving, equal in value to the taxpayer's loss of capital, does not take place somewhere else in the community—not a very probable state of affairs unless the capital tax is very heavy.' In any case, she says, 'this is a long period consideration; if a serious degree of "capital consumption" did appear to be taking place, it could always be compensated by new public investment.' *Public Finance* (1948 reprint), p. 232.

Mrs Hicks seems to take the position that capital taxes involve a loss of capital to the taxpayers but that it is made up by compensatory saving. It is not clear what this loss of capital stands for. Does it stand for the loss of existing capital assets to individual taxpayers? Or, does it refer to the fall in current investment because of the disincentive effect of capital taxes? If the former, there does not follow any loss of capital to the community as a whole because the existing aggregate capital remains intact and there is therefore no fear of a 'deterioration in the community's provision for the future relative to its provision for the present.' If the latter, it is not clear how the loss in question is offset by any compensatory saving and even when it is, how it embodies itself into investment.

PART II

CAPITAL TAXATION AND INDIAN ECONOMIC DEVELOPMENT

CHAPTER 5

CAPITAL TAXES AND DEVELOPMENT FINANCE

THE problem of economic development is in essence one of mobilizing current resources of the community for purposes of investment. And in an economy where, for some reason or other, investment is not taking place at the desired level, and where the government considers it advisable to take upon itself the function of making good the deficiency in the rate of investment, the question of the government's sources of finance assumes great importance.

THE PROBLEM OF RESOURCES

It was observed in Chapter 4 that in an emergency a government could raise its resources in four possible ways: (a) enhancement and/or imposition of regular taxes; (b) imposition of special short-period taxes; (c) non-inflationary borrowing; (d) currency and credit inflation. Deficiency in the rate of investment may become quite an emergency when the general standard of living of a community is already very low and even that is endangered. This happens when the rate of increase in investment does not secure to the economy that rate of increase in national product which corresponds to the rate of increase in population. In industrially advanced economies, the deficiency in the rate of investment is usually a short-term cyclical phenomenon and the government's job is not so much to make up the shortfall in the community's investment, as it is to fill up the gap between, what Keynes described as, the aggregate supply function and aggregate demand function.¹ The revival of aggregate demand should bolster up business confidence and, therefore, stimulate the pace of investment which had received a temporary setback. The emphasis in a situation like this is put on State outlays on non-competitive social investment which takes the form of expenditure on education, public health, sanitation etc., or even direct monetary assistance to those sections of the community who have the highest marginal propensity to consume. The underlying idea

¹ J. M. Keynes, *General Theory of Employment, Interest, and Money* (1936), p. 25.

is to inject into the system a certain amount of effective demand so as to offset the sag in the aggregate demand function. In an underdeveloped economy, however, the State is called upon to play a more positive role. The economy, left to itself, does not generate investment at a rate sufficient to ensure a continuing increase in the people's standard of living and, as a result, the divergence in living standards between advanced economies and backward areas is on the increase. Hence, the need for deliberate action. And it is here that the State steps in. A frontal attack has got to be made against the inhibiting forces.

In underdeveloped economies, the forces which inhibit growth in the rate of investment and therefore in the rate of increase in national income operate primarily on the supply side. Concentration of remedial action on the demand side could not solve the problem. It would rather worsen the position. Because of the rather inelastic supply position of the existing resources the injection of new demand would only increase competition on the use of the existing limited resources and thereby initiate a rise in prices. The subsequent rise in costs and wages and, therefore, again in prices takes the shape of a spiral process leading prices to a higher and still higher level. In a situation like this there is a danger not only of misdirection of investment into non-essential channels like the building up of inventories for purposes of speculative profit-making but also to the decline in total investment because of the postponements made in expectation of less expensive times.¹

The shortage of investment in an underdeveloped economy requires an approach more directly aimed at the creation of an additional supply of resources than is the case in an advanced industrial economy suffering from a temporary decline in investment. As it is, with the usual institutional background of an underdeveloped economy, the normal working of the market forces does not leave for investment more than a very small fraction of the current product. To increase this proportion, the government should go behind the market forces and find out the maximum amount that could be diverted by deliberate action towards

¹ Prof. R. Nurkse has perhaps rightly emphasized that even in an underdeveloped economy, the demand side of investment could not be overlooked. But the aspects of demand which call for attention in this case are, as is evident from his account, not the same as when the economy suffers from depression in aggregate demand. *Problem of Capital Formation in Underdeveloped Countries* (1953), Chapter 1.

investment, after making provision for the necessary consumption requirements of the community. It is in this respect that one can draw a parallel between a government faced with an emergency like war and a government faced with the urgent necessity of initiating a rate of investment higher than is possible to achieve without purposive direction on the part of the government. In both cases the decision about the allocation of current output between consumption and investment is taken not in obedience to the interplay of the market forces but in spite of that interplay.

CURRENCY AND CREDIT CREATION

The question that remains to be answered is: How does the government collect these additional resources for investment? Currency and credit creation is regarded as an unsuitable tool, not only because of the regressive character of the forced saving that it imposes upon the people, but also because of the misdirection of investment that it is likely to cause. A genuine fear is expressed in many quarters that inflationary financing of investment might cause actual diminution in total investment. The adverse effects of an internal price-rise on the balance of payments position of the economy is yet another drawback to this device. In spite of all these drawbacks, this is the device which attracts the most because of the ease and speed with which a government can resort to it. And there are people who, although aware of the pitfalls in the path of inflationary financing, recommend its use, but in mild doses. The reasons adduced in favour of this view are: (a) the impact of additional money on the economy is dampened by the people's propensity to hoard—a propensity which is very common in underdeveloped areas; (b) in all underdeveloped areas there is a large non-monetary sector which contributes little to saving and investment; a mild dose of inflation will bring this sector into the orbit of the money economy and thus make it more effectively contribute to the process of investment; (c) a certain amount of currency and/or credit creation is consistent even with sound monetary policy designed to avoid inflation and facilitate economic development because of the inherent need for the expansion in money supply to match the increase in output.¹

¹ *IMF Staff Papers*, Vol. III, No. 3 (1954), 'Economic Development with Stability', p.353; V. K. R. V. Rao, 'Deficit Financing, Capital Formation and Price Behaviour in an Under-developed Economy', *Indian Economic Review*, February 1953.

The above three considerations have a certain amount of justification. Given a certain propensity to hoard, increased incomes should lead to an increase in the amount of cash needed by the private sector for hoarding. To the extent the government satisfies this demand for additional cash it secures a transfer of real resources from the private sector to the public sector. In the same way, the incursion of money into the non-monetary sectors of the economy reduces the stock demand for real resources and releases a certain amount of resources for investment into productive channels. Finally, there is an increased transaction demand for cash in the economy in consequence of the expansion of incomes and the money created by the government to meet this demand becomes one of the sources for financing the developmental outlay.¹

The justification for the creation of currency or credit on the above grounds is perfectly valid and, so long as monetary expansion does not go beyond the limits set by the above criteria, there is hardly any ground to fear an inflationary rise in prices as a consequence. There is, however, a possibility of overlooking an important aspect of this type of currency or credit expansion. Monetary expansion intended to satisfy the increased demand for cash does not induce an additional amount of saving in the economy. It secures only a re-direction of saving from the private sector to the public sector. The constructive aspect of this type of money creation lies in the fact that while in private hands real resources are put aside merely to satisfy the propensity to hoard, in government hands it can be put into really productive investment which can be expected to contribute to a rise in real income. Monetary expansion can secure an increase in the economy's saving (i.e. release of current resources from current consumption) only by raising the general level of prices and this would in general take place after the additional money requirements of the economy referred to above are satisfied. It has already been observed that, as a means of stimulating demand for investment, monetary expansion and the resultant inflation are likely to defeat their purpose and also that as a means of supply of saving the burden of inflation is distributed in a rather regressive fashion. It is, therefore, desirable for a government, which sets itself the task of development, to seek to raise resources for that purpose by means other than inflation.

¹ *IMF Staff Papers*, op. cit.

STATE BORROWING

In the case of State borrowing whether in the form of funded loans floated in the open market or in the form of small savings and other types of unfunded debt, one cannot overlook its voluntary character. A considerable proportion of what is collected by the State in this form would in any case be saved by the community and does not constitute a part of the aggregate demand for final consumption. In underdeveloped areas, where banking habits are not properly developed, people have a tendency to keep a good proportion of their current saving in the shape of cash hoardings.¹ Now, in so far as the current aggregate demand is concerned, the amount which goes currently into hoards withdraws to that extent the demand on current resources. Therefore, in spite of the fact that, later on, due to the popularity of, say, the State Post Office Savings Banks the hoards are transferred to these banks, the current aggregate demand remains unaltered. Of course, it is quite likely that a well-organized State campaign for popularizing these institutions, and for the need to restrict current consumption on grounds of national urgency, may yield a real addition to the community's saving. It is this part of the community's saving which helps to reduce the strain on resources of the new investment programme.

Being voluntary in character, State borrowing may, or may not, induce an increase in the community's saving. And, even when it does induce additional saving, the incidence of the sacrifice involved in forgoing present consumption does not follow a uniform pattern; it depends rather on the caprices of the individual contributors. It is, therefore, very doubtful if by borrowing alone it would be possible to restrict the community's consumption to a rationally calculated 'Cm', i.e. minimum consumption requirements of the economy.

TAXATION

The most effective way of securing the maximum amount of saving from the community is to enforce compulsory reduction in current consumption by means of taxation. A cut in total consumption outlay need not, and should not, entail a decline in the basic minimum consumption level for individuals who are already living near that level. Taxation should rather endeavour to cut down the maximum portion of the individual consumption

¹ U. N. Report, *Measures for the Economic Development of Underdeveloped Countries* (1951), p. 36, para. 102.

outlays over and above that level consistent with the incentive requirements of the economy. It is this consideration of economic incentives which stands in the government's way of lopping off all the incomes in excess of what is regarded as the essential minimum by way of taxation. And since even taxation of a very drastic nature might leave with the individual members of the community a certain amount over and above their individual consumption requirements, it is very essential that the State should try to withdraw the same by providing different types of State borrowing suited to different sections of the community.

It is, no doubt, true that a certain portion of the revenue collected in taxes represents the amount which would have been saved even in the absence of taxation. That this fraction would have a positive value, derives from a reasonably valid assumption that, in general, the tendency to save is a direct function of the increase in income above the essential level of current consumption. But taxation achieves much more than a mere redirection of private saving which was found to be the predominant characteristic of State borrowing. It aims at cutting down the non-functional¹ consumption expenditure to the minimum through a type of compulsion and makes available for investment outlays the amount thus saved.

THE OPTIMUM TAX SYSTEM IN A DEVELOPING ECONOMY

Given a certain pattern of distribution of income and property in the economy, the revenue yield of the optimum tax system maximizes itself at the cost of minimum loss in production in the private sector. The marginal increment of revenue under this optimum tax system would, in terms of use value, be just about the same as the marginal decrement of production caused by the imposition of the tax. The emphasis on use value is deliberate. If the government, or for that matter the authority which is planning the economic development of the economy, considers that it is most useful for the community to spend a part of its current resources on investment and that this investment can best be financed out of taxation, then the important question which remains to be decided is regarding the tax system to be employed for the purpose. The choice between the various tax systems is not one of selecting the system which yields

¹ The term has been borrowed from J. C. Stamp to indicate that part of the consumption expenditure which does not contribute to the personal efficiency of the worker; *Fundamental Principles of Taxation* (1926), p. 77.

maximum revenue but the system which could yield maximum revenue without causing more than minimum impairment to production.

According to Prof. Pigou, if taxes 'conforming in amounts to the distributional ideal could be made in a manner conforming to the announcement ideal, we should have from the standpoint of least sacrifice, the optimum means of taxing revenue.'¹ Prof. Pigou does not leave it to the socio-political system to take an independent decision regarding the distribution of income etc., within the community. Instead, he lays down that from the distributional point of view the ideal scheme is one which imposes equi-marginal sacrifice. He is aware of the fact that direct measurement involved in inter-personal comparison of individual satisfactions or dissatisfactions is unattainable and also that indirect measurement by objective tests is unreliable. But he insists on equi-marginal distribution of tax sacrifice on the assumption that 'groups of *prima facie* similar men will be mentally affected by similar situations in much the same way.'² He overlooks that within a group (and his group appears to be so comprehensive as to include an entire community) economic stratification itself creates a number of sub-groups and there would be marked differences in reaction to particular tax measures between various sub-groups and it would be difficult to say that the marginal satisfaction of income in the £200-300 income group is equal to, greater, or less than that in the £400-500 income group. The question regarding the comparison of inter-personal satisfactions has ultimately to be resolved in terms of value judgements. It is therefore considered more appropriate to assume (unlike Prof. Pigou) that the distributional pattern is determined by socio-political considerations, and it is within that pattern that we have to have an optimum amount of tax revenue.

The withdrawal of resources from the private sector through taxation will perhaps lead to a reduction in that sector of outlay on consumption and also perhaps investment not only because of the net reduction in resources available for use in that sector but also because of the deterrent effects of taxation. In one sense it amounts to transfer of resources from the private sector; in the second sense, it destroys the very resources. Assuming that the government's decision to devote a part of the community's resources to public investment is in the best interests of the community, the

¹ *A Study in Public Finance* (1947), p. 72.

² *Ibid.* p. 72.

transfer of resources to the government would be a desirable proposition. But to the extent that a section of the community curtails its production not because of the non-availability of resources but because of the lack of opportunities for making what may be regarded as adequate profits net of tax, the community is made the poorer than it would have been if this consideration had not prevailed or if the government could have had the resources without recourse to the type of taxation which reduces profit prospects.

The main argument in the preceding three paragraphs may be summed up in terms of symbols.

$U(T)$ — Use value of tax revenue 'T' to be employed on public investment.

$f(T)$ — Use value of tax revenue 'T' for private consumption forgone.

$fP(C)$ — Use value of the amount of change in private production of consumption goods because of the disincentive impact of taxation.

$fP(I)$ — Use value of the amount of change in investment in the private sector because of the disincentive impact of taxation.

Obviously, before a tax is levied, the government, or the planning authority, must try to equate the use value of the tax revenue collected and the use value forgone as a result of the tax. That is,

$$U(T) = f(T) + fP(C) + fP(I)$$

Assuming that $fP(I)$ could also be written as $UP(I)$ i.e. use value of investment to the community is the same for what is now proposed to be undertaken by the State and for what was to be undertaken in the private sector, we get:

$$U\{T - P(I)\} = f\{T + P(C)\}$$

Therefore, the relationship between the two functions is:

$$\frac{U}{f} = \frac{T + P(C)}{T - P(I)}$$

In an economy where investment is undertaken entirely by the State and is therefore not affected by the imposition of the tax, 'P(I)' would be zero and therefore the essential requirement would be:

$$\frac{U}{f} = \frac{T + P(C)}{T}$$

Assuming that the functions 'U' and 'f' are invariant for the time

being, it is the variables on the right-hand side of the equation which have to be manipulated in such a way that the equilibrium is secured. The nearer 'U' is to 'f' the greater the need for reducing 'P(C)' and 'P(I)' (i.e. for reducing the disincentive effects on private production). It is clear that the case for taxation would exist so long as $U\{(T - P(I))\}$ is greater than $f\{(T + P(C))\}$ and the optimum tax scheme is one which secures the maximum revenue and still maintains the balance between the two sides.

CONSTITUENTS OF THE OPTIMUM TAX SYSTEM

The optimum tax system would be a combination of those taxes which, while yielding the maximum revenue, impinge the least on incentives. The criterion to be followed in the selection of particular taxes will be precisely the same as in the case of the tax scheme as a whole i.e. the achievement of equi-poise between the investment use of the marginal increment of the tax and the consumption use of not only the tax increment forgone but also of the amount of decline in production caused by the imposition of this particular tax. It would be easy to deduce that the different taxes within a tax scheme would show the same equi-poise at the margin. But some taxes would be yielding higher total revenue than the others. That is because, in some cases the stage of equi-poise is reached later than others. Since an optimum tax scheme secures the highest amount of revenue before reaching the stage of equi-poise, it could be taken as a direct inference that the constituents of such a scheme would be those which are capable of securing the highest revenue before their negative effects assume a magnitude comparable at the margin to the positive effects of the corresponding investment.

THE SCOPE OF CAPITAL TAXES

This brings us to the question about the place of taxes on capital in a developing economy. A good deal has been said in earlier chapters about the economic effects of different taxes on capital. It is a distinct advantage common to all the three types of the capital taxes that their deleterious effect on incentives to work (including the incentive to invest) is not very strong, because the tax in these cases is related not to effort but to past accumulations and therefore comes into calculations regarding economic effort in the present and in the future in an indirect way. Since the disincentive effect of capital taxes on production is not so strong, they should commend themselves to an authority planning the development

of an economy wherein it is intended to provide adequate scope to private enterprise to partake of the productive functions of the community. In this mixed type of economy, the effects of taxation on work incentives can be ignored only at the community's peril. Suffice it to say that the peril arises from the fact that production in the private sector may fall below the level which the community (or for that matter the planning authority) regards as essential, after taking into account the tax-financed investment that the government itself undertakes. In this process of balancing, the planning authority's calculations may be made in terms not of the prevailing money values of the transactions concerned but of social benefit. Hence, the emphasis on the use of the term 'use value'.

Now, in an underdeveloped economy, in order to break the vicious circle of low national income causing low investment and therefore lower incomes, a certain amount of consumption has got to be forgone so as to increase the rate of investment. The ideal way to do this would be to restrict consumption directly at those points where it is considered to be the least essential economically and also socially. But direct controls are rather hard to administer in underdeveloped economies and may also be financially too expensive. The next best method is to cut down the purchasing power in the hands of the people through taxation. People secure purchasing power in return for the work that they put in, and if taxation gives the impression of an impost on reward for work it weakens the incentive to work. It is important therefore that the relationship between tax and reward for work should be kept as remote as possible. With just the minimum of resources at the disposal of an underdeveloped economy, it can ill afford any reduction in production caused by the weakening of the work incentives. It is a matter of economic history that during the early stages of their development in countries like the U.S.A. and the U.K., direct taxation of incomes hardly existed. The governments in these countries relied for their revenue mainly on indirect taxes such as excises and import duties and on direct taxes such as taxes on land and other types of property. It is perhaps true that these taxes were not properly administered and also that the property taxes were, the worst administered. But the fact remains that the systems of taxation in these countries abstained from imposing a direct tax on the reward from work.

The most significant periods in terms of rate of growth were

the middle half of the 19th century in the case of the U.K., and between 1870 and 1913 in the case of the United States. In Britain, a beginning was made towards the direct taxation of income in 1799 under the strain of the Napoleonic Wars but it had to be abandoned in 1806. In 1842 again, Sir Robert Peel introduced an ungraduated income tax (with an exemption limit) of 7d. in the £ as a temporary measure. The measure was never repealed but the rate was lowered from time to time, except during the Crimean War when it reached the figure of 1s. 2d. In 1874, the rate was as low as 2d. Although the rate had to be raised gradually in subsequent periods because of the expanding demands for public outlay on the exchequer, the highest rate reached was 1s. 2d. in 1910. In the U.S.A., on the other hand, a beginning in taxation of incomes was made only in 1911, when an income tax was introduced by the State of Wisconsin. In 1913, the Federal Government was able to adopt it on a nationwide scale. It is quite clear that in both the countries direct taxation of income was either very insignificant or non-existing during the crucial stages of their development. According to Prof. A. H. Hansen, who surely is not unaware of the other factors which contributed to the high rate of growth in the United States, the vast expansion of the nineteenth century would undoubtedly have proceeded less rapidly 'had as heavy a tax burden applied to income and property then as now.'¹

SELECTION AMONG CAPITAL TAXES

While it is true that capital taxes do not impinge very heavily on work incentives it has to be conceded that the supply of work is fairly income-inelastic in the case of a very large portion of the working population in the community. The merit of capital taxes in so far as their influence on work incentives is concerned comes into clear relief when considered in the context of a highly progressive tax which has to be paid by persons in high income brackets. In underdeveloped countries, where a government has decided to step up on its own the rate of investment, it is very important to ensure that the resources are canalized into the government sector in such a way that the private incentives to invest and to produce are harmed the least. Herein lies the appeal of the suggestion referred to in Chapter 4 regarding the replacement of the income tax in the high income brackets by a

¹ *Fiscal Policy and Business Cycles* (1941), Chapter XVIII on 'Early Finance Methods'.

capital tax. Of course, in considering this proposal, it has to be kept in mind that a capital tax detracts to some extent from the motives to save and is, therefore, likely to increase the taxpayer's propensity to consume.

Of the three capital taxes, only the annual capital tax is a regular source of revenue which can be relied upon to withdraw the active purchasing power from the private sector. Death duties do, no doubt, constitute a regular source of revenue in the sense that a certain number of persons would be dying every year and that this number bears a fairly constant relationship to the total population, but the major portion, if not all, of the revenue collected from death duties represents not the active purchasing power but the inactive one coming out of tills and coffers. It is important to note that the collections from death duties do not exercise a direct check on the private sector's demand for consumption because of the understandable tendency on the part of the individual taxpayers to treat this form of tax liability as a capital charge. Moreover, the awareness of the liability to death duties might weaken the motives to save on the part of the taxpayers in so far as the individual fortunes are accumulated with the intention of bequest after death. This means that the government outlay on investment financed out of the proceeds of the death duties may prove to be more expansionary than is indicated by equation (6) in Chapter 4. While it may still be desirable to impose death duties to check the increase or even to reduce the disparities in capital ownership, and therefore of opportunities and income, the fact remains that the re-spending of revenue collected in this form would add to the aggregate effective demand in the economy and set in motion expansionary forces.¹ As a source of developmental finance in an economy not in need of buoyancy in aggregate demand, death duties have little to commend themselves. The annual capital tax, on the other hand, should qualify as a redoubtable regular source of finance, because as a charge recurring year after year it will, in all likelihood, be met by cutting down current consumption expenditure.

AN ANNUAL CAPITAL TAX

It was suggested in Chapter 4 that in order to secure the

¹ The argument holds whether the outlay is for investment or for final consumption. We have already seen that any suggestion that the proceeds of death duties should be earmarked by the government for investment purposes is based on fallacious reasoning. See Chapter 4, *supra*.

maximum advantages attributed to an annual capital tax, the tax should be applied in such a way that it enables the government to reduce the rates of tax applying to higher income brackets under a highly progressive tax. Now the assumption of an already existing highly progressive income tax is not applicable to most of the underdeveloped countries.¹ But it could still be argued that where the government in an underdeveloped economy is faced with the choice between augmenting the progressivity of income tax and the imposition of the annual capital tax in order to raise additional revenue, the latter should receive precedence over the former.

An annual capital tax could be made either proportional or progressive in rates. In comparing the effects of a proportional and progressive tax, the important consideration is that of an exemption limit. A proportional tax with a high exemption limit will have to impose a higher rate than a proportional tax with a lower exemption limit, in order to secure a given amount of revenue. While as between a proportional tax and a progressive tax with the same exemption limit, it could be said that the progressive tax falls more heavily on the margin, the same could not be said when comparing, say, a proportional tax with a higher exemption limit and a progressive tax with a lower exemption limit. In the latter case the tax on the margin may or may not be heavier for the progressive tax. The difference in disincentive effects of the two would depend upon the extent to which each relies on the group of taxpayers whose elasticity of supply of work (including enterprise) is likely to be small and is not much affected by considerations of tax payment. Persons in higher capital brackets often happen to be in higher income brackets as well. The decision to invest on the part of persons belonging to this group may, therefore, be adversely influenced by a high annual tax on capital. Their decision to save would also receive a setback because of the high liability which every new accrual to individual capital incurs. These latter considerations argue for moderation in the progression of an annual capital tax.

A CAPITAL LEVY

As regards a capital levy, the fact that it is a once-for-all impost restricts its usefulness as a regular source of developmental finance. It can at best help in mopping up purchasing power

¹ India's case is rather an exceptional one in this respect and is dealt with in Chapter 7.

over a short period provided the instalments of tax liability are properly related to the disposable purchasing power of the taxpayers after they have met their minimum consumption requirements. Even when this condition is adequately fulfilled there will still remain the possibility of the capital levy instalments not being paid entirely by cutting down current consumption expenditure. That would be because of the awareness of the fact that the capital levy has been imposed just for once. Of course, the provision for instalment payment is an attempt to give, as far as possible, the complexion of a recurrent tax to the capital levy and it should go a long way to persuade the taxpayers to meet their liability in this respect by curtailing their current outlay. But the danger of greater leakage in this case than for a straightforward recurrent tax will remain.

Now, the period to be covered by instalments has, as already indicated, to be long enough to permit of adjustment of the annual instalment to the amount which can reasonably be spared by the taxpayer.¹ But this period should not be so long as to give this tax liability the semblance of an unjustified and inequitable impost. The occasion for such a feeling arises if the payment of capital levy is spread over a rather long period during which capital ownership is likely to undergo a substantial change (and this is a fairly reasonable assumption) with the result that people continuing to pay capital levy instalments may no longer be in possession of the capital, on the basis of which the liability was fixed in the distant past. The taxpayer is certain to smart with a sense of unfairness when he sees his better placed compatriots escaping a liability for which he is being penalized just because he happened to own a certain amount of capital at some specific date in the past, whereas his compatriots accumulated it after that date.

In view of the above limitations of a capital levy, it could not be regarded as a useful continuing source of finance for a developmental programme extending over a long period. But it can still be considered as a means of canalizing current resources towards public investment in the initial stages of development. In the underdeveloped economies, the immediate problem is one of

¹ This suggestion does not argue for the fixation of instalments by the tax authorities in every individual case. It would suffice if the authorities were to fix the instalments for various capital-ownership groups on a consideration, in general terms, of our criterion with a provision for suitable adjustments in individual hard cases.

breaking the vicious circle and the most effective way to lift the economy out of this circle is to increase somehow the rate of investment in the initial stages of planned development. It is felt that this could be done by means of a capital levy. At any time, in any economy, however poor as a whole, a certain amount of non-functional current consumption is going on in the higher income and property groups. This non-functional consumption does not contribute to the efficiency of the productive system but most of it is so very habitual that ordinarily people would not think of its various items as unnecessary or avoidable. A capital levy of a reasonable magnitude with a general provision for payment by instalment over a number of years should be able to give a jerk to the people's habits and they might be forced to save on items which were hitherto regarded as almost essential. By the time the payment of a capital levy is over, higher investment in the economy should have created higher incomes and higher saving and lifted the economy out of the vicious circle and it would perhaps be possible to secure increases in investment thereafter without the necessity of repeating the capital levy.¹

THE PROBLEMS OF ADMINISTRATION

Many of those who concede the theoretical case for an annual capital tax and even for a capital levy hesitate to suggest them as practical propositions because of the insuperable administrative difficulties said to exist in putting them into practice. Dr Dalton was an ardent advocate of the imposition of a capital levy in Britain in order to effect a speedy liquidation of the huge public debt which had piled up during the First World War. He was at pains to prove that the valuation of assets for the purpose and the collection of a capital levy would not constitute a really formidable problem.² It is unbelievable, but true, however to find him so completely taken in by the arguments adduced by Seligman to establish the impracticability of a general property tax precisely on grounds of difficulties of assessment.³ There is hardly a shred of doubt

¹ The argument would not sound far-fetched when compared to suggestions for external assistance. In both cases it would be essential that the increase in income consequent on the initial increase of investment should as far as possible be diverted to investment. If a capital levy succeeds in accustoming the richer sections to a lower standard of luxurious spending, it should not be unreasonable to hope that even after the capital levy payments are over, their luxurious spending will take time to revert to its former level.

² *The Capital Levy Explained* (1923), pp. 30-38.

³ *Public Finance* (1929). p. 137.

CHAPTER 6

PLANNING AND TAXATION IN INDIA

IT is proposed to devote this chapter to the consideration of the financial aspects of economic development which is taking place in India and the role which taxation as a whole has been assigned to meet the requirements of development. The main justification for including this chapter in this study is to bring out as clearly as possible the trend in recent thinking in India regarding the role of taxation as a means of development finance. For it is this general attitude which conditions to a great measure one's reactions to a proposal for additional taxation, be it for raising the existing taxes in scale and/or in scope or for introducing new taxes.

PLANNING IN INDIA

That some sort of planned and concerted effort would be needed to lift the country out of the morass of poverty was being continually emphasized by Indian economists for decades. It was only during the concluding stages of World War II that this urge for planned effort crystallized itself into a number of plans outlining the immediate economic objectives and the programme to be followed for the attainment of these objectives. The earlier attempts at the presentation of plans were confined to private individuals. The State, as it were, was forced into the current of planning by the interest roused in the country by the private plans.

THE BOMBAY PLAN

Early in 1944, eight prominent industrialists of Bombay published a plan which was popularly known as the Bombay Plan.¹ It was a fifteen-year programme for economic development covering both private and public sectors. The programme was to be undertaken in three stages, each covering a period of five years, with development outlay rising from Rs. 14,000 million in the first five years to Rs. 29,000 million in the second five years and

¹ *A Plan of Economic Development for India*, by Sir P. Thakurdas and others, Penguin Special (1945). This publication will, hereafter, be referred to as 'the Bombay Plan'.

Rs. 57,000 million in the third five years. The objective was to secure a threefold rise in national income (estimated at Rs. 22,000 million, in terms of pre-war prices at the time of the presentation of the plan). Taking the population increase into account, per capita income was expected to rise by about 100 per cent during this period.

As regards the role of finance in their programme, the framers of the Bombay Plan emphasized that planning was to be conceived primarily in terms of commodities and services. Therefore, money or finance was completely subservient to the requirements of the economy as a whole and must be treated merely as a means of mobilizing the internal resources of the country in materials and manpower. Actually, in the context of economic planning finance could not play a more positive role than the one mentioned by the drafters of the Bombay Plan. Unfortunately, in practice they assigned to finance a much more passive role. After having determined the magnitude of resources required to fulfil their programme, they almost took it for granted that the necessary finance would be available. It was not considered essential to examine in detail the ways and means most suited to raise the necessary resources.

In this frame of mind, the Bombay planners, quite naturally, contented themselves by indicating in a very general way (a) the sources which might be drawn upon to meet the external costs of the programme, and (b) the extent to which saving could be forced on the community through the creation of money. As regards saving which was to be tapped directly, this is how they arrived at the total figure:

In India, taking into account the fact that the present standard of living is extremely low and that no provision has been made for the increased taxation which a planned economy would necessitate, we do not assume that more than 6% of the national income on an average would become available for investment during the period of the Plan. On this basis the total amount which could be obtained over the whole period from the savings of the people would be in the neighbourhood of Rs. 4,000 crores.¹

The precise form in which this amount might be secured, that is, 'whether by the State in the shape of taxation or government borrowings, or by private investments, is a question which can

¹ 'The Bombay Plan', op. cit. p. 54.

only be considered, when the plan is ready for execution, in the light of conditions then prevailing.¹ The Bombay Planners leave one in little doubt that to them it was not of much significance how this part of the domestic savings² was to be channelled into the hands entrusted with the task of undertaking the requisite development outlay. Their attitude, it appears was that finance would somehow materialize and that it was no use worrying about it at that stage.

THE PEOPLE'S PLAN

The Bombay Plan was the precursor of quite a number of blueprints on planning in India. Most of these were no more than a general profession of beliefs and ideologies. But the one issued by the Indian Federation of Labour in the same year as the Bombay Plan was much more than that. It was a ten-year development programme, with a frankly socialist bias, and was much more ambitious than the Bombay Plan. While the Bombay Plan provided for an outlay of Rs. 43,000 million in the first ten years for the entire country, the People's Plan envisaged an outlay of Rs. 150,000 million³ (that is, nearly 3.5 times higher than the Bombay Plan) in the same time-space for only that part of the country which was known at that time as British India.⁴ This divergence in the magnitude of outlay was reflected in the targets set for the increase in national income. Under the Bombay Plan, national income would increase by nearly 90 per cent in ten years⁵ whereas the People's Plan visualized an increase of about 320 per cent in the same period.⁶

¹ Ibid. p. 56.

² In distinguishing between internal resources collected for purposes of development through taxation and borrowing, government or private, and those obtained through deficit financing, the Bombay Plan treats only the former as savings. Such a procedure is liable to mislead one to believing that the rest of the internal resources (i.e. those not covered by savings in this restricted sense) does not entail forgoing current consumption.

³ The estimates of outlay were stated to be in terms of the average of 1935-39 level of prices. Compared to the average for 1931-39 adopted in the Bombay Plan, the average price level for the period 1935-39 was higher by about 2 per cent.

⁴ Covering nearly 80 per cent of the country's population. See Census of India, 1941.

⁵ The Bombay Plan envisaged a threefold increase in national income in 15 years; it did not indicate its stage by stage progress in this increase. Our estimate of the increase after 10 years is based on the postulated spread of development outlay over this period.

⁶ The People's Plan gave estimates of increase in output in the agricultural and industrial sectors without indicating whether or not this increase covered

THE BOMBAY PLAN *VS.* THE PEOPLE'S PLAN

A little digression might be permissible in order to explain the widely divergent targets aimed at in the two plans referred to above. The People's Plan was able to visualize development outlay and therefore the ultimate increase in national income primarily because of three reasons.¹ (a) The People's Plan started with the assumption of an initial investible surplus in domestic resources which was more than twice the figure assumed by the Bombay Planners. While in the Bombay Plan the initial saving-income ratio was placed in the region of 8-10 per cent, the People's Plan set off with an assumed ratio of over 20 per cent. (b) The People's Plan envisaged the increase in output at a rate somewhat faster than the Bombay Plan. The overall capital-output ratio for the Bombay Plan works out to 2.3 : 1 as compared to the People's Plan's ratio of 2:1.² (c) The marginal rate of saving reached under the Bombay Plan does not go beyond 20 per cent of additional income generated as a result of development, whereas under the People's Plan the rate rises from about 30 per cent in the first five years to around 40 per cent in the second five years.

It is worth noticing that the marginal rate of saving (this includes not only the savings directly tapped but also those forced through inflationary finance and those obtained by having a surplus trade balance with the rest of the world) assumed in the Bombay Plan was from the very beginning to be nearly thrice as high as the average rate of saving, whereas in the People's Plan the marginal rate even in the second five years was to be just

the tertiary sector. We assume that the increase in output in the tertiary sector is covered in the estimates for the agricultural and industrial sectors.

¹ The various relationships highlighted in this paragraph are not expressly stated in either of the two plans.

² In neither of the two plans—the Bombay Plan and the People's Plan—is the relationship between increase in production and development outlay stated in these terms. In the Bombay Plan, a capital-outlay ratio of 2:1 was stated to have been assumed for outlay in the industrial sector. Since the overall ratio for the plan works out to 2.3:1, the outlay in the rest of the sectors combined must have been assumed to be slightly less productive in this restricted sense. In the People's Plan, the following three different ratios were postulated:—

(a) Land reclamation.	.. 1 : 2
(b) Other agricultural outlay	.. 1 : 1.2
(c) Industrial outlay	.. 2.4 : 1

It appears that in respect of outlay other than that incurred directly on agricultural and industrial development, no direct contribution was assumed to accrue in the form of increased productivity. Presumably, this was the sort of outlay meant to sustain the above ratios.

about twice the average rate assumed to prevail at the start of the planning period. Still, in spite of the accelerated pace of saving at the margin under the Bombay Plan, the gap in the actual rates of saving remained sufficiently wide.

Whatever may be said in regard to the extreme optimism which permeated the assumptions underlying its estimates, it may be said to the credit of the framers of the People's Plan that they showed greater awareness of the need to secure coherence between resource and outlay plans. The Bombay Planners did not, it appears, regard resource planning as very important. They left it to be settled by *ad hoc* decisions taken on the spot in the light of the conditions prevailing at the time. In the People's Plan, on the other hand, it was emphasized that the speed of economic development was dependent on the extent to which investible surplus became available to the investing authorities.¹ In fact, one of the justifications adduced for radical institutional reforms in the economy was that they would facilitate the flow of investible surplus into the hands of the State, which was to be made responsible for all the development outlay under the plan. For instance, in regard to the industrial sector it was stated that 'since industries will be mostly owned and controlled by the State, it should be possible for the State to divert that part of the income from the industries which it thinks necessary for the purpose of reinvestment.'² And for the agricultural sector, the framers of this plan expected that the problem of securing the diversion of the investible surplus would become simpler as the movement for collectivization developed.³ According to them, given this institutional framework for the economy, the turnover tax would tap the industrial surplus and the land tax would tap the agricultural surplus.

The two plans mentioned above are a fairly representative sample of the two main trends of thought in the country on the subject of economic development, viz., (i) that wedded to the private enterprise economy, and (ii) that advocating a state-controlled economy. From the standpoint of the present study, the important thing to note in the two plans is the difference in emphasis on the role of taxation in tapping resources for development purposes. Under the Bombay Plan, out of nearly 83 per

¹ The People's Plan, op. cit. p.39.

² Ibid.

³ Ibid.

cent¹ of the resources to be secured internally, only 40 per cent were regarded as being available through direct channels. The other 43 per cent² were to be had through deficit financing. Under the People's Plan, on the other hand, the entire 97 per cent³ of the domestic resources had to be secured directly and no provision whatsoever was made for deficit financing. It is significant to note that the Bombay Planners showed themselves to be extremely reluctant to break new ground and to devise new ways of directly obtaining savings for purposes of development. They would rather saddle the economy with inflationary pressures by resorting to deficit financing of a magnitude as would create a situation where, according to their own reckoning, 'practically every aspect of economic life will have to be so rigorously controlled by the government that individual liberty and enterprise will suffer a temporary eclipse.'⁴ The attitude adopted in the People's Plan represents the other extreme whereunder no provision was made for deficit financing regardless of whether or not it might to a certain measure be beneficial to the economy. In this plan, the turnover tax and the land tax were to be the mainstay. Death duties and compulsory borrowing, including withdrawals from the inflated reserves of the industries, were suggested, particularly with a view to tide over the initial stages of planning when resources might be somewhat difficult to obtain.⁵

¹ As to the other 17 per cent, the impact of which would not be felt on the demand for current resources within the country; 10 per cent was to be had in releases from the country's sterling balances accumulated with the Bank of England during World War II and 7 per cent was expected to be raised in loans from abroad. It is worth mention that in taking credit for the release of sterling balances, their rupee value was not adjusted in terms of 1931-39 level of prices. If adjusted, the amount available on this account would be smaller by over 50 per cent.

² This comprised (a) created money, 34 per cent, (b) surplus trade balance, 6 per cent, and (c) liquidation of hoarded gold, 3 per cent. Perhaps the last item needs an explanation. Gold hoards could be liquidated either by replacing them with currency or by creating bank deposits of equivalent value. But, it has to be conceded that the income effect of the new money thus created will not be significant.

³ Only 3 per cent of the total outlay was expected to be covered by sterling balances. It appears that a lower figure had been assumed because of the adjustment made in the rupee value of sterling balances in terms of 1935-39 level of prices.

⁴ The Bombay Plan, op. cit. p. 55.

⁵ The People's Plan, op. cit. p. 41. Death duties were recommended also in the Bombay Plan but only as 'a means of correcting the existing inequalities of wealth.' See p. 87.

THE OFFICIAL PLANS

The need for planning was given official recognition late in 1944 when a new department of planning and development was set up by the Central Government. Much of what was done by this department comprised the constitution of a number of panels for surveying internal physical resources. It also asked the other departments of the Central Government and the Provincial Governments (as they then were) to draw up their respective schemes for post-war development. The Advisory Planning Board, set up in 1946, brought together these different schemes and it was estimated that they would involve a total expenditure of Rs. 12,950 million over the next five years. For the programme thus drawn, the Central Government was to provide about Rs. 10,000 million and the rest was to be found by the provincial governments by tapping their respective sources. The Board does not appear to have undertaken a detailed examination of Central or Provincial finances. But on the basis of a set of general assumptions, it said that, of the Central figure of Rs. 10,000 million, Rs. 5,000 million could be had from current revenue surpluses and Rs. 5,000 million from public loans. Revenue surpluses, it was assumed, would accrue primarily because of the expected fall in the current commitments of the governments rather than from any increases in tax receipts.

Because of the subsequent political changes in the country and the urgency of the immediate economic problems, planning received a temporary setback.¹ With the consolidation of the political authority of the new government and some relaxation in immediate strains, the demand for planning revived. The Planning Commission was set up in 1950 to formulate a national plan. Although the final version of the First Five Year Plan came out only in December 1952, some of the development schemes covered under it had been started much earlier. The period of this First Plan extended from 1 April 1951 to 31 March 1956. In what follows, we attempt an examination of those sections of the Plan which are relevant to the present study.

THE FIRST FIVE YEAR PLAN

Estimates made by the Planning Commission suggest that

¹ We have here in mind the economic problems arising immediately after Independence in August 1947 on account of (a) the partition of the country into two separate and entirely autonomous units and (b) the subsequent interchange of population of over ten million between India and Pakistan.

the resources devoted to investment in the few years immediately preceding the Plan amounted to something like five per cent of the net national product. Assuming that (a) this rate of investment was just about enough to maintain the existing per capita levels of income of the growing Indian population (the average rate of population growth being about 1.25 per cent per annum); and (b) the capital-output ratio as a whole was nearly 3:1, with an average gestation period of two years, the Commission's figure of 5 per cent for investment seems to be near the mark. The validity of the above assumptions could perhaps be questioned on more than one score. But in the absence of adequate statistical information to corroborate it, any other set of assumptions replacing the above would be equally open to dispute.

It may be useful to state that even though the Planning Commission did not think in terms of wholesale nationalization of the means of production or of the elimination of private enterprise, it considers that a progressive widening of the public sector would be an essential prerequisite of economic development. In terms of magnitudes, while the total net investment was expected to rise from about Rs. 4,500¹ million in 1950-51 to Rs. 6,750 million in 1955-56, the estimated increase in public investment would be from Rs. 1,850 million to Rs. 4,800 million in the same period. This meant that the share of public investment would, on the Commission's own reckoning, rise from 41 per cent to 70 per cent of the total annual net investment in the economy. There could obviously be no doubt as to the direction in which the official planners in India were proceeding. It seems to have been firmly planted in their minds that, for the present, if they want to step up the rate of investment in the country, it has to be done primarily through the public sector.

Now, over the five years of the First Plan, the total domestic resources which, according to the Planning Commission's calculations, would be currently available for investment was around Rs. 27,500 million.² Since the figure for investment in the public sector during this very period was put at about Rs. 16,500 million, it meant that as much as 60 per cent of the assumed total

¹ This is the figure which the Planning Commission takes into account for purposes of making meaningful comparisons. The First Plan, op. cit. p. 48.

² During the course of the Plan the target of total development outlay was extended by Rs. 2,880 million. The items of expenditure to be covered are such as cannot be treated as investment in the strict sense. As regards the impact of this increase on financing, the presumption seems to be that it would be met by deficit financing.

domestic savings would need channelling through the public sector. Actually however, a large part (about 48 per cent¹) of the planned outlay in the public sector was expected to be financed out of external resources, including releases from the sterling balances accumulated during World War II, with the result that the incidence of public investment programme on current domestic savings was going to be much lighter. It would amount to a little over 30 per cent of the total domestic savings.

It will be noticed that withdrawals from the sterling balances have been treated as external resources. The Planning Commission chose to treat them as part of 'deficit financing' because 'the sterling balances do not form part of the Central Government; they are the counterpart of savings forced on the community at large during the last war, and are held by the Reserve Bank as the country's foreign exchange reserve and backing to the currency.'² In the strict sense of the government having to run down its balances or to borrow from the Central Bank to cover its total budgetary deficit this is no doubt deficit financing. But for the economy as a whole it does not constitute deficit financing,³ because the additional demand created by the government's deficit expenditure is offset by the import surplus represented by the withdrawal from the external balances. In terms of foreign trade multiplier, one could say that the income-destroying coefficient of the import surplus offsets the income-creating coefficient of equivalent domestic outlay by the government. If we assume that both the coefficients are nearly equal,⁴ the government outlay would not have any expansionary effect on the economy. In fact, to draw on the accumulated balances held abroad and to receive new loans and grants from foreign sources are the same in so far

¹ i.e. Rs. 7,920 million out of the total planned outlay of Rs. 16,500 million. This is on the assumption that the internal resources available for investment would be reduced by the amount by which the development outlay stipulated in the Plan comprised the 'non-investment' expenditures.

² The First Plan, op. cit. Note to p. 61.

³ Both for the Bombay Plan and the People's Plan discussed earlier in this chapter, we do not regard it as deficit financing. On the contrary, we have treated as deficit financing the favourable trade balance visualized in the Bombay Plan as a resource available for financing development.

⁴ We do not propose to go into the how and why of this assumption because of the restricted scope of the study. Perhaps one could build up a theoretical model like the Haavelmo Theorem of Balanced Budget Multiplier for a 'balanced' balance of payments as well, if this assumption is changed to vary the initial impact.

as the income effects are concerned.¹ If, as is argued sometimes, investment financed from external resources is inflationary because it stimulates certain complementary domestic expenditures, that would apply to external loans and grants as also to withdrawals from sterling balances.

External resources apart, about 32 per cent of the investment in the public sector was to be financed out of loans raised by the government; these loans might be in the form of straightforward stock market borrowing or small savings or even private contributions to funds and deposits operated in the public sector. The remaining 20 per cent was to be shared equally between the profits of commercial enterprises run by the government and savings from the tax revenue.

Two important points emerge from the foregoing description of the broad financial scheme of the First Plan:—

(a) External resources were assigned in the Plan a very important role in stepping up the pace of investment. To a large measure, this reliance could be justified on the score that the vicious circle of poverty could only be broken up with some outside help.

(b) Just about 10 per cent of the total planned investment in the public sector was to be financed out of the government's current revenue, excluding profits from the State-controlled commercial and industrial concerns which contributed another 10 per cent to the pool of investible resources.

It would mean going much beyond the bounds of this study, if the first point is taken up for detailed examination. But one thing is clearly indicated in the progress reports of the Plan, i.e. that external assistance has not been made available to India at the rate assumed in the Plan. Even the withdrawals from the sterling balances have not been up to the schedule.² On present indications, the maximum amount forthcoming from external sources for public investment would be around Rs. 3,500-4,000

¹ The *IMF Report* is somewhat obscure on this point. It tries to explain the phenomenon as one of restoration of money supply. A direct analogy with other external assistance, to our mind, clears up the issue more easily. *IMF Staff Papers*, Vol. II, No. 3.

² According to the Progress Report for the first half of the year 1954-55 recently issued by the Planning Commission, releases from sterling balances up to the end of 1954-55 amounted to around Rs. 1,500 million. This figure has more recently been revised and put at Rs. 830 million as the net decline in foreign exchange reserves till the end of the fourth year of the Plan. Progress Report for 1954-55 (May 1956), p. 7.

million as against the original estimated figure of Rs. 7,920 million. This creates a gap of nearly Rs. 4,000 - 4,500 million in the Plan.¹ If one takes into consideration the amount by which the Plan was later on enlarged to include expenditures, mostly of the type which could not be treated as investment in the strict sense of the term, the gap would be higher by Rs. 2,880 million. Then, there is the question of actual performance under the receipt heads like public savings from current revenues, current profits of State-owned commercial concerns, and public borrowing. In the first three years of the Plan, the accrual under these heads had been just about 43 per cent of the Plan-estimate for five years. According to the latest progress report the accrual under these heads for the entire plan-period would be about 86 per cent of the Plan-estimate. Whatever be the shortfall on this account, the gap in resources would have widened to that extent.

How did the government cover this gap? In order to cover this gap, the government could either cut down the planned outlay, or finance it through expansion of credit and currency,² or else cut down partially the planned outlay and finance the rest through monetary expansion. In India, the government had actually enlarged the programme outlined in the final version of the Plan by about Rs. 2,880 million. Obviously, the government had, for the moment at least, decided in favour of monetary expansion. It would be useful to follow briefly the process by which the government moved in that direction during the course of the Plan period.

The first year of the Plan was not a particularly auspicious year. The economy was riding high on the crest of the inflationary tide under the impact of the world shortages created by the Korean War and the domestic food shortage caused by successive failures in rainfall. The general index of wholesale prices (base: 1939=100) rose from 397 on 24 June 1950 to the peak figure of 462 in April 1951. The government had, in these circumstances, not only to restrict its expenditure even at the risk of postponing outlays on development projects but even to take steps for a maximum draft on the liquid resources of the economy both by means of taxation and monetary control. The government accounts for

¹ The gap in relation to the Plan is actually wider by about Rs. 2,200 million, if the fact that external resources of this order were secured in 1951-52 for meeting current consumption demand is taken into account.

² It is assumed that the resources from taxation and borrowing could not be increased beyond the Plan figures.

the year closed, therefore, with an overall surplus of Rs. 103 million, in spite of an investment outlay of about Rs. 2,000 million.¹

The cessation of hostilities in Korea and the consequent relaxation of world shortages not only reinforced the domestic disinflationary policies in their effectiveness but went further and created a scare among the commercial classes. For a while, it appeared as if a severe depression was around the corner. In these circumstances, the government could afford to think in terms of relaxing tight control on its outlays, in spite of a fall in tax revenue mainly on account of export duties. The year 1952-53, closed with a deficit of Rs. 806 million. However, as the monetary control was rigidly maintained by the Reserve Bank of India, money supply with the public registered a net fall² in spite of the budgetary deficit. In 1953-54 also, the deficit was nearly as big as in the preceding year. However since the monetary control was relaxed, the deficit was complemented by an expansion in money supply to the extent of Rs. 938 million. Still, at the end of the first three years of the Plan nearly 60 per cent of the programme (in terms of outlay) remained to be undertaken. Naturally, this called for great acceleration in the pace of outlay. It is estimated that for the last two years of the Plan about 60 per cent of the increase in outlay over the level reached in 1953-54 was met by means of deficit financing and money supply expanded by no less than Rs. 4,000 million during these two years.

The Plan, as originally conceived, provided for a progressive extension of the government's role in the sphere of investment. But it relied very little for its financing on increased taxation. Almost 80 per cent of the total investment outlay in the public sector would, it was estimated, depend for resources on borrowing, both external and internal. Another 10 per cent was to be had in the form of profits of State enterprises. This leaves only about 10 per cent of the total requirements to be met out of current

¹ The figure for investment is derived on a pro-rata basis from the figures given in the Plan's Progress Report for 1953-54 on the assumption that the investment element of the Plan-outlay bears the same proportion (viz. 77 per cent) in the yearly figures as in the Plan figures for the entire five-year period. The First Plan, p. 48.

² Money Supply with the public (excluding cash reserves of the banking system) changed as under:

1951-52 = (-)	1,715	(Rs. million)
1952-53 = (-)	414	(Rs. million)
1953-54 = (+)	938	(Rs. million)

(Source: Reserve Bank of India's Report on Currency & Finance for 1953-54.)

savings from tax revenues. Actual events have turned out differently. Current savings from tax revenues and profits of State undertakings have tended to lag behind schedule and external resources have not been forthcoming on the expected scale. Public borrowing within the country did not bring in adequate returns in the first two years but it picked up in 1953-54. To the extent that resources were not to be had from expected quarters, the government resorted to deficit financing—a source highly discounted in the original Plan.¹

It is abundantly clear from what has been said above that in the peculiar circumstances prevailing in the country and because of the cautious monetary policy pursued for some time by the Reserve Bank of India, deficit financing did not generate inflationary pressures in the economy. Later, in view of the fact that restrictive monetary measures served, to some extent, to depress private investment activity, the Reserve Bank was advised to make suitable adjustments in its lending and rediscount policies. In fact, the report of the Committee on Finance for the Private Sector gives one the impression that it was suggesting a positively liberal credit policy even as a supplement to government's deficit financing.

The question of theoretical limits to deficit financing in an underdeveloped economy has been dealt with earlier in this study.² Quite possibly, they have not yet been reached in India. The deficit over the first few years of planning has not led to inflation. The question that has got to be faced (and this may have to be very soon) is: Can the government continue financing its investment programme in this fashion? One is tempted to say in reply: 'Yes, so long as it does not lead to inflation.' But the fear is that it will, once the restraints exercised through the monetary policy are relaxed. In an economy where 95 per cent of the current incomes tend to be consumed,³ it is not difficult to visualize how easily the combined investment decisions of the public and private sectors may outstrip the relatively small amount of savings and give rise to strong inflationary pressures. Therefore, it is time that serious thought was given to

¹ The original Plan contemplated deficit financing only as an offset to releases from sterling balances. 'This, so far as it is possible to visualize now, may be regarded as the safe upper limit to deficit financing.' The First Plan, p.61.

² See pp. 63 and 64, Chapter 5, *supra*.

³ It is assumed that the marginal propensity to consume and the average propensity to consume are quite close to each other. This conforms to the opinion of the I.M.F. experts in their report on Indian development programme.

the rest of the contents in the government's financial armoury to find out if the existing contents could be more effectively employed and also if new items could be added to the armoury so that investible resources could be raised without resort to inflationary financing.

THE ROLE OF TAXATION

It is interesting to note that a plan like India's First Five Year Plan, which was not very ambitious in the targets of investment outlay set down for the economy as a whole, has been built on such weak and uncertain foundations. One principal reason for this weakness seems to be the hesitation of the planners to assign to taxation its proper role in the financing of the public investment programme, and this too in spite of the realization that, 'if the proportion of the national income covered by taxation is as small as it is in India today the public sector cannot, in the immediate future, increase its savings to any significant extent.'¹ Still, the financial programme outlined in the Plan did not presume any radical changes in the technique of taxation. Half-hearted measures for a surcharge here and a duty there were recommended.² In all, the measures of additional taxation were expected to yield about Rs. 300 million a year on average. Additional revenue of this order would hardly be sufficient to cope with the increasing demands of administration and existing social welfare

They say that '*a priori*, it would be expected that in low income countries, the pressure to apply additional income to an increase in consumption would be so great that no significant increase in the savings ratio could be expected.'
IMF. Staff Papers, op. cit.

¹ The First Plan, p. 49.

² Measures suggested in the Plan were:

		(Rs. million)
(i) Surcharge on land taxation	..	.. 68
(ii) Betterment levies and increase in irrigation rates	..	.. 59
(iii) Death duties	..	.. 43
(iv) Increase in sales-tax rates	..	.. 51
(v) Other taxes	..	.. 75
		Total 296

These figures represent annual averages based on the five-year estimate given in the Plan, and might be somewhat misleading. The pattern of yield over time was, it is natural to assume, expected to follow the expansion in planned outlay, rather than to spread itself evenly over the period. Only on the basis of such an assumption, could the Plan expect the tax revenues to be higher by Rs. 700-800 million in 1955-56 compared to 1950-51. The First Plan, p. 52.

departments. For, after all, this amount represented hardly 5 per cent of the current public expenditure in 1950-51 (the base-year for the Plan) in respect of these departments. The Plan does not seem to have given sufficient importance to this consideration in their original assessment of finances, although it became clear at a fairly early stage in the process of finalizing the estimates that some increase in expenditure under these heads had got to be taken into account.¹ The whole discussion of this issue seems to have been carried on in terms of inter-federal financial arrangements instead of in the context of the overall financial requirements for the Plan.

The point which has to be emphasized with all vigour is that a country like India, which has already in existence a reasonably well-established taxation machinery that could serve as a nucleus of a progressively expanding tax-administration, should not be content with collecting just about 7 per cent of the national income in the form of taxes—a proportion that is one of the lowest in the world. It is sometimes argued, and perhaps with some measure of justification, that taxation by itself has hardly ever helped a country in financing its economic development. In highly advanced economies of the U.S.A., and the U.K., where taxation is very high compared to the relevant figures for national output,² the tax proceeds have expanded and are being utilized to meet the increased current commitments in the public sector either on defence or on social welfare.³ In less developed economies of Latin America and of countries like Ceylon, where tax proceeds absorb a high proportion of their national outputs, the revenue is usually just about enough to meet the minimal public commitments.

Economic history furnishes us with only a few instances where tax revenues have been channelled into investment. In Japan, taxation machinery was geared into action for purposes of economic development because the State started evincing active interest in stepping up the pace of investment. In the U.S.S.R., where the process of development has been more rapid, the State, unlike in Japan, assumed direct responsibility for taking and

¹ The First Plan p. 59.

² i.e. national output magnitudes, when put on a basis comparable to the tax proceeds.

³ It is arguable indeed that the expenditure on social welfare itself comprises a sort of investment.

effecting investment decisions. Here too, taxation provided the bulk of the resources. Thus, there are three sets of countries:

- (a) economically well developed countries, which are using their large tax revenues on current non-investment items of public expenditure;
- (b) economically less developed countries, which are using relatively large revenues to meet their minimal current public commitments; and
- (c) countries which have used their large tax revenues for purposes of investment.

It is true that a very few countries are known to have had large tax revenues and to have utilized them for economic development. But this does not entitle one to conclude that taxation is never able to provide 'resources of an order large enough to initiate economic development.'¹ It may be conceded that there is no necessary correlation between large tax revenues and high rates of utilization for economic development. This only means that even when a large tax revenue is collected, it may be utilized for the non-investment purposes of the State. But if an economy is in more urgent need of public investment² than, say, social welfare expenditure, it is conceivable that, as happened in Japan and the U.S.S.R., tax revenues should be so employed. The nature of government expenditure itself may, like many other factors, condition the taxable capacity of a community. But in so far as there is scope for expanding tax revenue within the limits set by the overall production levels and minimum consumption and incentive requirements, or by the existing income and property distribution, or even by the very fact that the government spends on investment instead of on social services, it must be fully explored, so that taxation is employed to the optimum for increasing the savings within the economy.³

As it is, India does not come in any of the three categories referred to above. She does not fulfil the basic condition of having a large tax revenue relative to her national output. One

¹ K. N. Raj (see *Economic Weekly*, Annual Number, 1954) puts forth this view while arguing his case for a progressive socialization of industrial profits.

² The term 'public investment' has been used in a somewhat broader sense than usual. It covers not only direct investment outlays by the State but also private outlays financed out of State subsidies or loans.

³ The case for taxation as a source of development finance has been explained at length in Chapter 5 above.

could not discuss the propriety or otherwise of using tax revenues for accelerating the pace of investment without first finding out the tax-potential of the economy. Comparisons with other countries are useful only up to a point. Disparities that exist in the vast number of *ceteris paribus* conditions, implicit or explicit behind such data, severely limit the usefulness of these comparisons. Still, it does not mean that taxes in India yield such a small revenue because there is little scope for their expansion. It may only mean that traditional forms of taxation are perhaps unsuitable for an economy like this. In any case, every form of taxation has to be studied in detail with a view to discover new avenues of extension. This applies not only to taxes which are in vogue in the country but also to other taxes which might usefully be introduced to expand the economy's resources for economic development.

It is to be regretted that, in the discussion on planning in India, taxation has not received the attention it deserves. The Bombay industrialists were surprisingly unenthusiastic about taxation in the blueprint drawn up by them for the country's development. They pitched their faith on inflationary finance even if it led to a rigorous control by the State on individual liberty whereby 'freedom of enterprise will suffer a decline.' The People's Plan, on the other hand, relied almost entirely on unconventional forms of taxation suitable for a State-operated economy. This plan eventuated into a combination of State-controlled industrial sector with a collectivized agricultural sector where the land and outlay taxes would, as in the U.S.S.R., bring in the bulk of the resources. When it came to proposals for the transitional stage, the authors of this plan were content with rather vague recommendations. As regards the official First Five Year Plan, its attitude towards taxation may aptly be described as lukewarm. It conceded that taxation 'is a matter which cannot be overlooked in framing a programme of development especially when it is clear that with net savings of about 5 per cent of the national income, the rate of progress that can be attained will be extremely limited.'¹ But the framers of the Plan seem to have convinced themselves too soon that the scope for taxation in India was limited and that, at best, tax revenues could just about be kept near 7 per cent of the national income as in 1950-51.

No better evidence could be had to substantiate the allegation

¹ The First Plan, p. 51, para. 16.

that the Indian Planning Commission was diffident toward taxation than its own. The First Plan says that since as much as one-third or more of total tax revenue is derived from certain limited strata of society, the burden of taxation spread over the rest of the community is correspondingly lighter and that relatively small increases in the rates of taxation on the latter will help to add significantly to total tax revenue.¹ In regard to specific taxes, the Plan cites the case of Japan where land taxation provided the initial resources required for development,² whereas in India 'land revenue contributes at present only about 8 per cent of the total tax revenue as compared to about 25 per cent in 1939.'³ As regards income taxation, it says that, 'there is undoubtedly a strong case on grounds of equity for making the higher income groups bear a large share of the burden of development.'⁴ But all these arguments should have led the Commission to assign a really positive role to taxation in its financial scheme. Instead, it contented itself with measures of marginal type which hardly mattered to the overall financial requirements of the Plan.⁵ What the Commission has said in regard to taxation in general or particular taxes continues to be valid after 1955-56 (i.e. at the end of the First Plan) because these proposals fail to rectify the position to any appreciable measure.

That the specific measures for tax-increase suggested in the First Plan were *ad hoc* measures agreed upon with the State governments is clearly indicated in the Plan. If in this process, capital taxes, which form the subject-matter of the present study, get a raw deal, one could not complain much. The only capital tax which got mentioned in the Plan is the estate duty. The estate duty had been recommended as 'an important equalizer of incomes and wealth'.⁶ The emphasis on this particular

¹ The First Plan, p. 49, para. 11.

² Ibid. p. 50, para. 12.

³ Ibid.

⁴ Ibid. p. 51, para. 13.

⁵ Still worse is the fact that whatever tax-increases had been proposed were, with the exception of the estate duty, to be levied and administered by the State governments. It is at the State level that the general efficiency of tax machinery is not uniformly good all over the country. The greater the strain on it, the larger the scope for evasion. One would have welcomed a suggestion for greater coordination between the Central and State tax administrations, even in spheres specifically demarcated under the Constitution, whereby tax-experience of the more efficient units was made available to others.

⁶ The First Plan, p. 41, para. 36.

aspect of the estate duty stemmed from a strictly pragmatic consideration of lending an egalitarian colour to the Plan. It is our purpose to outline the scope for capital taxes including the estate duty in India and indicate their usefulness or otherwise for the purposes of economic development. The chapters that follow cover this analysis.

CHAPTER 7

THE ROLE OF CAPITAL TAXES IN A DEVELOPING INDIA

THE GENERAL CASE FOR CAPITAL TAXES

TWO important points have emerged from our analysis in the last chapter. (i) The Indian Government has decided to take upon itself the major task of increasing the pace of investment within the economy through public investment programmes. (ii) There is very little indication that adequate measures are under contemplation to ensure an increase in savings on a scale corresponding to the proposed increase in investment.

The performance of the First Plan has shown that even the few measures for additional taxation recommended in the Plan have not been promptly put into effect, and where they have been introduced, the additional revenue was only just about enough to meet the additional non-investment commitments of the public sectors. As a consequence the investment expenditure had to be financed in a large measure through budgeting for deficits on a scale not envisaged in the Plan. If these deficits in the government accounts have not resulted in inflation, this can be explained partly by the operation of certain favourable influences in the economy such as the coincidence of a period of unusually bountiful rainfall and the resulting bumper crops with that of the Plan. Besides, it is possible that investment in the private sector did not only fail to achieve the targeted increase but registered a decline in comparison to the pre-Plan level. To the extent that private investment declined, it should have offset the increase in public investment, and therefore the aggregate investment demand on current produce remained more or less unaltered. This would be so, in spite of the fact that a considerable part of public investment was financed by the creation of money. Still, there was, perhaps, some increase in public investment which could not be said to have taken place at the expense of private investment and which too was financed by the creation of money without leading to inflation. Now some increase in money is essential in a newly developing economy both to satisfy the requirements

of the freshly monetizing sectors and to cope with the increase in real income. But if the created money were to exceed these bounds substantially, it would have inflationary repercussions without assuring a real increase in aggregate investment. If, therefore, it is intended to secure a real increase in investment beyond the safe limit set for monetary expansion, it is but meet that other methods of rechannelling real resources should be sought. A curb has got to be applied to current consumption. Hence, the emphasis on taxation.

A rethinking in the sphere of taxation appears to be an essential part of the whole plan for the re-orientation of a stagnant economy into a developing economy. In our selection among taxes to be employed for securing a transfer of resources to the public sector emphasis has to be placed on a tax which (a) induces maximum increase in saving (i.e. curtailment in current consumption expenditure) in the private sector, and (b) exercises minimum restraint on investment activity within the private sector. We have already examined the role that could be assigned to different capital taxes in any new scheme of taxation designed to serve the needs of development.¹ In this chapter, it is proposed to investigate their scope in the context of India's development needs and indicate the broad outlines which these taxes may possibly take in the country. A beginning with capital taxes has already been made with the introduction of the estate duty. But the estate duty is just one form in which death duties may be levied. In this chapter, therefore, we shall deal, *inter alia*, with death duties in general and leave the more detailed analysis of the recently introduced estate duty for the chapters that follow.

Already there exists in India a highly progressive tax on non-agricultural incomes levied at the Central level. The agricultural incomes are taxed by the State governments in the form of land revenue which in some cases is supplemented by a progressive surcharge called, the agricultural income tax. The federal tax on non-agricultural incomes absorbs a fairly large proportion of the income in the higher ranges, and as has been rightly pointed out in the Plan, any increase in revenue under this head could be expected only through the elimination of evasion rather than through further enhancement of rates. The marginal rate of tax applying to the slab of income above Rs. 150,000 is perhaps the highest in the world. The tax applicable to this

¹ Chapter 5, *supra*.

slab is 88.5 per cent in India compared to corresponding rate of 87.5 per cent in the U.K. (The maximum rate in the U.K. is, however, still higher going up to 95 per cent for income above Rs. 200,000.) As regards land taxes the Plan called for some upward revision of the existing rates because assessments in most cases had been fixed in money terms before World War II and have not been revised although the prices of agricultural products had gone up nearly four times compared to their pre-war level.

The justification for an upward revision of land taxes is reinforced by the decision of the planners in India to allocate a large fraction of the investment outlay towards the development of agriculture. To provide for an increase in agricultural productivity, and therefore, in real income in that sector without planning for the redirection of these gains into investment channels militates against the objective of maximizing saving at the margin, an objective which must be kept in view if the purpose is to ensure a continuing increase in investment. But the actual proposals in the Plan for the revision of land taxes (excluding irrigation rates and betterment levies, both of which are in the nature of fees charged for specific services) are expected to secure an increase of less than 14 per cent in their annual yield as compared to the planned increase of over 17.5 per cent in the agricultural output. That is, in spite of the proposed revision in land taxes the marginal rate of tax on agricultural incomes would be smaller than the average rate.¹ Thus, of the twin objectives of tax revision: (a) to restore the real value of land taxes to the pre-war level; and (b) to secure higher tax yield at the margin, neither would be within the reach of the Plan proposals.

The extremely cautious attitude adopted in regard to land taxes only illustrates the extent of conservatism with which the entire question of taxation has been tackled in the Plan. It is, in our view, an essential prerequisite to obtaining tangible results from planned development that the planners should be prepared to give up, where necessary, the traditional attitudes so as to be able to adopt bolder and newer techniques. This

¹ Not in the sense of a regressive tax schedule but in the sense that the projected increase in taxation yields in revenue an amount which as a proportion of the increase in income is less than the existing effective rate. In other words

$$\frac{dT_a}{dY_a} < \frac{T_a}{Y_a}$$

where 'Y_a' stands for total agricultural income and 'T_a' for total revenue from the tax on agriculture.

applies as much to the collection of resources as to their application. The capital taxes, which form the subject-matter of our study, should, on this criterion, stand or fall on a proper appraisal of their contribution and not because of prejudices which have grown thick over time because of certain historical coincidences.

PROBLEMS OF ADMINISTRATION

Too often a proposal for a tax on capital has suffered neglect because of the adverse impression that has come to grow round the taxation of property. Some of the taxes on property have, no doubt, been known to be very ill-administered. This was due primarily to the defective recording and valuation of property. But are the difficulties involved really so insuperable? We have reasons to argue that they are not so. In most of the countries death duties are levied in one form or the other, and in countries with properly established tax machinery, they are being adequately administered. There is not much reason why a tax machinery which undertakes the listing and appraisal of property at death could not be expanded so as to be entrusted with the regular listing and appraisal of all the private property within the community. The task, we have already observed,¹ is not so formidable as it might seem at first glance. But the difficulties to be encountered obviously would be greater in countries where the existing tax administration is not sufficiently developed or has not had adequate experience in the recording and valuation of property. The Inland Revenue in the U.K. is, for instance, better equipped for undertaking this task because of its long experience in property valuation connected mainly with the death duties than the Central Board of Revenue in India where only a beginning has just been made with death duties.

In India, the proportion of private property which may be susceptible of valuation through stock exchanges is at present much smaller than in the United Kingdom. A far larger proportion in India is accounted for by realty. Realty is subject however to some sort of *ad valorem* taxation. For land, the 'annual value' constitutes the basis of assessment to land revenue and for urban realty the liability to tax is usually calculated on the basis of its rental yield. The recording of realty in India should therefore be an easy operation if full use is made of the records maintained for the existing taxation. As regards its valuation, the task would be somewhat complicated. But it would be far less difficult if

¹ Chapter 5, *supra*.

undertaken with the co-operation of local valuation personnel than without them. Of course, this enlistment of local expert co-operation in valuation has to be organized on a regular basis. Valuation operations have to be conducted on a nationwide scale under some sort of central direction in order to ensure maximum amount of uniformity in the fixation and application of valuation criteria and in the standards of accuracy. The operations we have in view will be much less expensive if both the appraisal of the capital and annual values are undertaken together. In India, re-appraisal of agricultural property is long overdue. Even for non-agricultural realty, it would be advisable to make a fresh re-appraisal, if only with a view to putting it on a uniform basis for the entire country.¹ For business assets which are not owned on a joint-stock basis, and which cannot therefore be valued on the strength of stock-exchange quotations, a different procedure has to be followed. For the recording and valuation of such assets, collateral evidence to be found in the income tax returns should prove of considerable use, and the valuation staff should be allowed free access to them. The greatest difficulty will arise, however, in the case of personal possessions which can be easily concealed. The problem is already there in regard to death duties. Perhaps for a more regular tax on capital when the tax authority is known to be always on the track, the people would be less inclined to conceal such items.² Still it must be admitted that some personal possessions would escape even the most inquisitorial of techniques.

For a regular tax on capital, it will also be essential that the valuation lists of property are kept up to date. Once the initial lists are prepared (and this might take anything like two to three years) the subsequent task of keeping them up to date should be less involved and could be entrusted to a central valuation office with a network of branches spread over the country. But questions might be raised regarding the costs involved in setting up an organization as extensive as the one envisaged here. It must immediately be conceded that if, for instance, an annual tax on capital

¹ Because, there is no plausible ground for disparities in valuation standards to exist within the country.

² Comparing a regular tax on capital with an irregular impost (he had a capital levy in mind), L. L. Price said that its one advantage was that 'opportunity is thereby offered for the amendment of mistakes which cannot be set right in what is already past and gone beyond recall.' *Economic Journal*, 1920, p. 69.

were being considered in isolation, the expense involved in valuation on the above scale would give cause for pause. But if we have in view a tax system which already includes death duties, local property taxes, and taxes on property income (as also income from other sources) the expense involved would be worth while.¹ In fact, if one takes into account the improvement in collections which is likely to follow the valuation organized in this way in respect of taxes other than the annual capital tax, the net additional expense of valuation (i.e. the additional cost of valuation minus the additional revenue yield under tax heads other than the annual capital tax) will not be high. It may even be a minus quantity.²

Effective administration of death duties and gift taxes, for instance, requires careful valuation of all types of assets when they are transferred by way of inheritance or gift. The availability of proper valuation data makes it unnecessary to institute separate detailed enquiries for the assessment of these taxes. The same could be said for other taxes which rely directly or indirectly on capital values for the purpose of assessing tax liability. It needs particular mention that many a proposal for a capital levy has been turned down in the past precisely on the grounds of the impossibility of securing a proper valuation of assets within the short time in which the levy is intended to be collected. But, if there already exists in the country a proper record of capital values in respect of all private property, the proposal for a capital levy would not be dismissed just on the score of administrative difficulties. In fact, the fear is that with such a record already in existence, the capital levy as a device of sporadic collections by the government may become too popular. Definite improvement shall take place also with regard to the taxation of income. Firstly, the existence of the inventory of property with the tax authorities will deter the taxpayers from concealing (or even from understating) income from property. Secondly, income from

¹ The Local Finance Inquiry Committee (India) expresses itself in favour of a central valuation organization even for the limited purposes of local rating. It says; 'While the taxing authority may continue to be vested in the local bodies, the detailed work connected with the preparation of the valuation list of all the properties within the jurisdiction of a local body should be entrusted to a central organization which will consist of trained valuers. A valuation department should be set up within each State to see that the valuation list is correct and up to date for each local body.' Report (1951), p. 90.

² *Shoup Mission's Report on Japanese Taxation* (1949), Vol. I, pp. 86-7.

other sources will be less easy to conceal, if the major portion of such income is intended for embodiment into property.

PROBLEMS OF EVASION

The problems of evasion are closely connected with those of tax administration. Recording of property and its valuation are, no doubt, administrative problems, but incomplete recording and undervaluation create problems of evasion. Hence, much of what has been said above could as appropriately be included in the discussion of evasion. The problem which needs separate mention is the likelihood of the people increasing their holding of such forms of property as are most difficult for the tax gatherers to detect. Some people might already be keeping some of their assets in this form in order to conceal their income from the tax authorities. The capital taxes may, it can be argued, reinforce this tendency. It is an argument which cannot be dismissed summarily. In fact, it poses a real problem. The dimensions of the problem, however, can be overstated.

The assets of the type referred to above are such as do not yield income in the restricted sense. Some of these assets would be held by persons even if there were no taxation because of the direct satisfaction derived from the mere fact of having them in one's possession. Jewellery and gold belong to this category of assets. But would these assets be held beyond a certain limit? To hold these assets involves a cost in the form of income (in the restricted sense) which would have accrued if the property were held in straightforward income yielding assets. If taxation can be avoided on jewellery and gold holding but not on income yielding assets, then the net cost to the taxpayer of keeping the former is lower than it would be in the absence of taxation. However, so long as a capital tax does not swamp the entire income from property, some cost will remain and this should prevent the taxpayer from going too far in accumulating his property in the form of such 'dead assets', as some would like to describe them.

AN ANNUAL CAPITAL TAX FOR INDIA

The arguments in favour of an annual capital tax in India can be derived from the discussion as it has proceeded so far in this study. It was set down earlier in this chapter that, in the context of development, a tax should not only be able to enforce savings (i.e. reduction in consumption expenditure) in the community but also ensure that the existing investment suffers minimum

adverse effects because of the disincentive caused to enterprise. An annual capital tax appears to qualify well as one such source of the government's development finance because it combines with the advantage common to all capital taxes of keeping remote the connexion between tax-payment and reward for work or enterprise the other advantage of exercising the maximum income effect on the current consumption demand of the taxpayers.¹ Secondly, the tax being assessed on capital value sets some premium on risky enterprise² and may therefore contribute to the growth of healthy interest in risky ventures—a tendency, if developed on proper lines, can contribute significantly to economic development. Thirdly, a separate tax on capital in addition to a tax on income makes the tax system more equitable than if income alone were to be the basis of taxation.³ Fourthly, in the case of India the introduction of an annual capital tax will also help to rectify to some extent the imbalance of the existing tax incidence in so far as the agricultural sector of her economy is concerned.⁴ Increased government investment on agriculture may be expected to raise capital values in the agricultural sector and therefore the yield from the annual capital tax.

While the recording and valuation of capital assets on the lines indicated earlier should be considered an essential part of any scheme to impose an annual capital tax, a start could be made immediately by assessing it on the strength of the capital values declared by the taxpayers themselves. The adjustments that are necessary could be effected subsequently in the light of the regular valuations when they are completed. To minimize undervaluation by taxpayers, a provision could be made for a surcharge in the case of undervaluations of more than, say, ten per cent.⁵

EXEMPTION LIMIT

An exemption limit of Rs. 10,000 is suggested in order that the proposed annual tax can reach those sections of the income earners who are not being touched by the existing taxes on income.

¹ See Chapter 4, *supra*.

² See Chapter 2, and Chapter 4, *supra*.

³ See Chapter 4, *supra*.

⁴ The addition to tax revenues because of the improvement in yield from the already existing land taxes, viz. land revenue and agricultural income tax, as a result of the revaluation of land will exercise a supplementary influence in this very direction.

⁵ This follows Sydney Arnold's suggestion in regard to the imposition of a capital levy in the United Kingdom. *Economic Journal*, 1918.

Tax assessment at the lower reaches of the income scale should be easier in a country like India, where salaried classes comprise barely two to three per cent of the total working population, on the basis of the capital ownership than current earnings. A lower exemption limit is recommended also because it helps in the withdrawal of purchasing power from the hands whose income-propensity to consume at the margin is exceedingly high. It is at this level of income that the leakage to consumption out of increases obtained in real income tends to be proportionally the greatest. To the extent that the new income generated as a result of development outlays goes to swell incomes of this type, some such measure naturally is called for.

RATE STRUCTURE

The tax being based on capital value has, of necessity, to be at low rates. The maximum rate should be light enough to be payable out of the current income, for the main purpose of this tax is to reduce not the taxpayer's capital but his wherewithal for current expenditure. As one goes up the income scale, the propensity to consume is known to be less and less.¹ While in the case of lower income groups the income propensity to consume may be approaching unity, for higher reaches of income it would be far less. If, therefore, considerations of redistributive finance are not so compelling (i.e. they can be deferred during the first few stages of development), the government should not insist on making the rate structure as sharply progressive as exists for the income tax. For the purpose of estimating the revenue potential of an annual capital tax it is proposed to adopt the following schedule of rates:—

<i>Capital Value over Rs.</i>			<i>Rate per cent of Capital Value.</i>	
10,000	—	50,000	..	0·20
50,000	—	100,000	..	0·33
100,000	—	200,000	..	0·50
200,000	—	400,000	..	0·75
400,000	—	800,000	..	1·00
800,000	—	1,500,000	..	1·25
above		1,500,000	..	1·50

¹ We are thinking here in terms of a static position and comparing the income propensities to consume between the income groups; we do not refer to a shift from one income group to another.

The rates may be taken to apply on a slab system with no exemption limit in so far as the properties liable to tax are concerned. That is, any property valued at over Rs. 10,000 in value shall be regarded as liable to the capital tax on the entire capital worth and not just on the excess over Rs. 10,000. A provision shall have to be made for marginal relief in the case of persons whose net wealth exceeds Rs. 10,000 by a very small amount. It is suggested that as a measure of marginal relief, the tax liability for such estates should not in any case exceed 10 per cent of the excess over Rs. 10,000. The provision may not rectify inequity altogether but will redress hardship to a very large extent.

YIELD

Clearly, the yield of the tax may not be substantial for the first few years in the absence of a proper record of private capital assets and their values. But as the revenue staff gains in experience and as taxpayers get accustomed to the submission of proper property returns the yield should pick up. In the absence of any direct evidence as to the magnitude of private property in India and its distribution, it is extremely hazardous to make an estimate of yield from this tax. Still, an attempt has been made to get some idea of its potential yield. It is estimated that tax receipts from this source will amount to Rs. 520-570 million per annum.¹ This alone should raise the total tax revenues of the public sector (i.e. of the Central and State governments combined) by about 7-8 per cent.² In addition, there must follow, for reasons stated earlier, considerable improvement in receipts from the existing land revenue and income tax as also from the taxes collected locally.

JURISDICTION

In view of what has been said before regarding the imperative need for organizing the valuation of property on a national scale and also of the advisability of dovetailing an annual capital tax with the existing income tax and estate duty, both of which are being levied by the Central government, it follows that the administration of the annual capital tax should be placed in the

¹ The details of the estimate and their basis are indicated in an appendix to this chapter.

² The combined tax revenues of the Central and State governments for the year 1951-52 amounted to Rs. 7,400 million. Our figures in respect of the public sector, it will be observed, do not cover the tax receipts of the local authorities.

Central hands. Besides ensuring uniformity in valuation and tax-incidence, it will also avoid all the anomalies which crop up because of the discrepant criteria of situs or residence which are usually adopted to demarcate the different tax jurisdictions within a country. The constitutional position in India on the question of the devolution of tax functions as between the Centre and the States is somewhat vague. Under the Constitution of India, as it stands today, the Centre can levy a tax only on the capital value of property other than agricultural land. It will therefore be necessary for the States to be persuaded to delegate, as most of them have already done in respect of the estate duty, to the Centre the title to levy on their behalf the tax on the capital value of agricultural land.¹ As to the distribution of the tax proceeds between the Centre and the States, it appears to us of secondary importance whether a part or the whole of these proceeds are handed over to the State governments. So long as the entire resources, which the different constituents of the public sector draw upon, are treated as comprising one single pool for purposes of financing development, and these resources are allocated between the various development projects on the basis of priorities set down for the country as a whole, the distribution of tax receipts as such between the Centre and the States or between the various States become a matter of mere accounting and classification.

A CAPITAL LEVY FOR INDIA

Recent suggestions for a capital levy in India have been motivated by either of the following two considerations. A proposal has been current for a once-for-all impost on private capital with a view to recompense the displaced persons from Pakistan for their loss of property. Such a proposal involves transfer of individual capital from existing owners to displaced persons. The aggregative effect of this operation on the economy may be felt through the disparities, if any, in the 'wealth effect'² on current expenditure of changes in capital ownership as between the old and the new owners. The 'income effect' of this operation may be taken as insignificant. The other proposal is to use the funds thus collected for purposes of development. This would, it is argued, enable the government to accelerate the pace of development

¹ The devolution of tax functions under the Indian Constitution and the distinction drawn between agricultural and non-agricultural sources of taxation are dealt with in some detail in the following chapter.

² See Chapter 3, *supra*.

to a considerable degree. We have observed earlier in this study¹ that a capital levy being in the nature of a non-recurrent liability tends to be paid by the taxpayers by reducing their capital assets. The income effect of such a payment is little and the draft on current spending of the taxpayers comes only through the slow-moving wealth effect. This being the case, the financing of the current government outlay on development out of capital levy receipts would be nearly as inflationary as deficit financing.

Now, if a capital levy as a means of development finance is nearly as inflationary as straightforward deficit financing, there is a case for resort to it only if the economy is, on a proper appraisal of the trends, found to be able to withstand an inflationary injection. But if it is a question of choosing between a capital levy and deficit financing as a means of inflationary finance there is not much to be said in favour of the former. In India, where the modern banking system covers in its operation only a fragment of the economy, the bulk of deficit financing has got to be done in the shape of direct issue of currency. One could not, therefore, equate in India deficit financing with public borrowing and argue that even as an inflationary device a capital levy may be preferable because it does not leave behind such problems for the future as are the inevitable consequence of public indebtedness.² Moreover, a capital levy is by its nature an emergency levy and its virtue lies in the people's faith in the government's intention not to repeat it. It could not be treated as a substitute for deficit financing which as a tool is available for much more frequent use.

A capital levy is, in any case, impossible to impose in India at this stage because of the virtual absence of a proper record of capital assets and their value. This consideration by itself is perhaps enough to reject any proposal for a capital levy. But even later on when a proper record does become available, it may not be advisable to resort to a capital levy with a view to meeting the expenditure requirements of the government. It was no doubt, suggested earlier in the course of this study that by providing for the payment of a capital levy in convenient instalments, it was possible to lend it in a large measure the character of a recurrent tax and also retain the advantage of minimum disincentive

¹ See Chapter 4, *supra*.

² T. Balogh argues that these problems could be avoided by a war-time capital levy. 'The Unimportance of a Capital Levy', Institute of Statistics, Oxford, *Bulletin*, Vol. 6, No. 3, 1944.

effects. If this is so, would it not be worth while for the government in India to introduce a capital levy and make it payable in suitable instalments extending over a period of say, twenty-five years? If we go by our estimate of the yield of the annual capital tax and also assume that the average effective rate of a capital levy applying to the entire taxable property would be 25 times the rates postulated for the annual capital tax, then the maximum rate applying to the highest property-group may be as high as 37·5 per cent. The yield from a capital levy of this magnitude should be of the order of Rs. 520-570 million per annum for a period of twenty-five years.

It could certainly be argued on the strength of the above estimate that if it is worth while establishing an elaborate valuation machinery for the annual capital tax, it might as well be so for a capital levy of the above type which assures an equal amount of revenue over an entire generation. The similarity between the two taxes is, however, not so close. With regard to the revenue yield, the annual capital tax would produce an increasingly higher revenue as development proceeds because the resulting improvement in the general economic position will be reflected both in the appreciation of capital values and in the increase in physical stock in capital ownership and, therefore, in the assessments based thereon. But for a capital levy the liability though discharged annually is fixed once and for all, and whatever changes take place in capital ownership either because of ups and downs in individual fortunes or because of the general movements in the economy the tax liability remains unaltered. Thus, while the yield from an annual capital tax may be expected to expand with the expansion in the economy, the yield from a capital levy will remain fixed. Further, in this fixity of its liability a capital levy could be likened to the existing land revenue in India which is fixed in money terms once and for all for a period ranging from 30 to 50 years on the basis of the annual value of land estimated at the time of the assessment. Whatever happens during the period between two assessments the liability for the land revenue remains unchanged. This is a quality which may commend itself to a budget forecaster but it makes the tax extremely ill-adapted to the purposes of development finance. If ever it were a question of choosing between an annual capital tax and a capital levy with instalment system of payment, there is little doubt that the choice will be for the former. As for meeting the requirements of development, accent must be placed in India on continuously

expanding resources. The annual capital tax is one such resource.

DEATH DUTIES IN INDIA

In India, a start has been made with an estate duty, whose detailed provisions will be taken up for analysis in the following chapters. The decision in favour of an estate duty as against an inheritance tax seems to have been influenced by the prevalent opinion that the former is a 'much more productive and efficient source of revenue'.¹ But revenue from death duties is not in nature similar to revenue from other recurrent taxes. The payment of death duties, as of a capital levy, exercises an insignificant income effect on the taxpayers. Their proceeds do not therefore represent a real resource which could be utilized by the government to meet its current expenditure, be it on current or on capital account. The importance given to revenue as a consideration weighing in favour of an estate duty seems to us ill-placed. And since equity considerations are better served by a tax which relates liability to the amount received rather than to the amount bequeathed, the start could as well have been made with a tax of this type instead of an estate duty.² More so, because the primary objective with which the estate duty was introduced in India was stated to be to rectify the glaring inequalities in the ownership of wealth.

Not only that the start made with the estate duty was wrong, there is something of a fallacy about this step. Transfers on death are one of the two forms of gratuitous transfers (i.e. transfers during one's lifetime and transfers on one's death). Since the estate duty subjects to tax only one form of gratuitous transfers, it is natural to expect property holders to turn to the other form of transfer which does not attract taxation. An estate duty, unaccompanied by a corresponding tax on the other type of transfers, is a differential tax on property transfers which do not take place until death. As a result, the balance is tilted in favour of lifetime transfers which can be made without incurring any tax liability. It is really doubtful if the high egalitarian objective set could ever

¹ G. F. Shirras, *Science of Public Finance* (1936), Vol. II, p. 524, and R. N. Bhargava, *The Principles and Problems of Inheritance Taxation* (1952), pp. 70-5.

² As the basis of a progressive impost, the share going to a beneficiary represents a better criterion than the whole corpus of the decedent's estate of which the share is but one part. This is a point which has not been seriously contested even by the strong supporters of estate duty.

be served effectively by an estate duty applying in isolation. Moreover, to draw a distinction between transfers on death and transfers before death appears iniquitous for the simple reason that the accretion of economic power in the hand of the recipient of property is not dissimilar in either case. We have therefore argued at great length in a subsequent chapter for the desirability of complementing the estate duty with the taxation of lifetime transfers.

In the First Plan credit was taken for a sum of Rs. 213 millions in respect of estate-duty collections as being a resource available for meeting development expenditure. To regard estate-duty receipts as on par with other tax receipts does not, however, appear to be the right procedure. Even though estate-duty receipts are a recurrent source of revenue, they do not represent a transfer of real current resources in the aggregate sense. To treat estate-duty receipts as part of the government's current revenues, as is done in the Plan's scheme of finance, gives the erroneous impression that these receipts are also available for meeting current commitments. It may be emphasized that our argument against showing receipts from the estate duty, or for that matter from all death duties and the like, as part of the government's current revenues does not derive from the need to secure some sort of correspondence between the revenue account of the private sector with the revenue account of the public sector, although that is a fairly important point and deserves to be taken into account. Nor do we base our argument on the distinction that is more commonly drawn between taxes paid out of income and capital.¹

¹ Professor J. R. Hicks is in favour of retaining the existing practice. He dismisses these two points on the plea that (a) accounting of government transactions 'must be based upon criteria which arise out of government's own transactions, not upon criteria which are relevant only to the other side of the transactions which concern the private sector of the economy,' and (b) 'from the point of view of the financial position of the government, an arrangement of accounts which was based upon the principle of excluding capital taxes from revenue would be less meaningful than one which paid attention to the distinction.' *The Problem of Budgetary Reform* (1948), pp. 63 and 64. If one goes by the first argument of Prof. Hicks one would have to rule out even some of the reforms in budgetary practice suggested by Prof. Hicks himself. Besides, there does not seem to be much justification why the existing practice of accounting receipts from death duties (we do not equate all capital taxes with death duties, or for that matter, with a capital levy payable in lump-sum) should be defended as 'based upon criteria which arise out of government's own transactions.' As regards his second argument, we endorse it in so far as it is meant to counter the argument based on the misleading distinction usually drawn

The reason for which a change in the existing accounting procedure in regard to death duties is suggested by us is based on the far more important consideration that since the payment of death duties does not cause the taxpayers to reduce their demand on current resources, the proceeds from this type of taxation cannot be considered as available for financing current expenditure in the public sector.

between taxes paid out of income and capital. But, it could not negative our plea for change. It must be emphasized that it is precisely for the reason that the showing of death duties as current receipts misrepresents the revenue position of the government *vis-à-vis* its current commitments, that to us a rearrangement of their accounting seems called for.

APPENDIX TO CHAPTER 7

AN ESTIMATE OF THE YIELD OF AN ANNUAL CAPITAL TAX IN INDIA

FOR an estimate of tax yield to have any claim to accuracy it is essential that one should be able to vouchsafe the reliability of the data relating to the tax base. In our case, the tax base is individual capital. In order to arrive at an estimate of yield from the annual capital tax, the minimum essential information we need is in respect of the total value of capital held by the individuals comprising the community. If our tax is progressive or proportional with an exemption limit, we also need to know the distribution of capital as between various ranges of ownership demarcated in the progressive tax schedule, or only as between the exempted and non-exempt ranges if it is a proportional tax of the type referred to above.

We have suggested that the annual capital tax in India should be a mildly progressive impost with an exemption limit of Rs. 10,000. Thus, we need for purposes of our estimate information regarding (a) the total value of capital owned by individuals who possess capital exceeding Rs. 10,000 in value; and (b) the distribution of this total value among the various zones in the tax schedule. Unfortunately, the information relating to capital ownership available to us is extremely fragmentary and has wide gaps. No attempt has so far been made to make out an estimate of the total value of private capital in this country. All that we have been able to do is to piece together the available information and to work out in an admittedly rough and ready fashion the estimated total value of capital owned by, and its distribution among, individuals coming within the purview of our tax. The results arrived at should therefore be treated with extreme caution. At their best they could be regarded as an index of the broad magnitudes involved.

For estimating the total value of capital in India, the economy has been dichotomized into rural and urban sectors. For the rural sector, the estimate takes into account three items of property: land, houses, and cattle. While in certain individual cases, there will surely be other items which comprise an important part of the total capital, the items other than the above three would constitute

a rather negligible proportion of the total capital owned in the rural sector.¹ As regards the urban sector, distinct items of capital are difficult to identify and evaluate primarily because of the lack of data relating to business assets. We have relied for this purpose on the income statistics of the Central Board of Revenue in India. The non-agricultural incomes from sources other than salaried jobs and professions have been capitalized on the assumption that a certain amount of capital ownership would be associated with all such incomes. It is on the strength of this very assumption that it has been possible to reconstruct for this sector the distribution of capital in India and thereby to apply the proposed rate schedule in an appropriate way.

CAPITAL IN THE RURAL SECTOR

As already stated, capital in the rural sector has been classified under three heads. The respective estimates are as follows:—

Land: The total cultivated area in India is estimated at 324 million acres, of which the single crop area covers about 288 million acres and the double crop area comprises 36 million acres.² We are treating all single crop area as dry land and double crop area as wet land. The average value of dry land is estimated at Rs. 500 per acre, and of wet land at Rs. 1,000 per acre.³ Proceeding on this assumption, it is estimated that not less than 30 per cent of the single crop area and 40 per cent of the double crop area is owned by persons with assets exceeding Rs. 10,000 in value.⁴ Thus, the total value of land area taken into account in our calculations will be:

¹ Especially after making suitable adjustment for hoarded wealth.

² The First Plan, pp. 153 and 373.

³ There is no doubt that land values diverge considerably from one part of the country to the other. Our device of adopting a general average for the entire country suffers therefore from serious limitations. But in the absence of sufficient information regarding land values even for the main regions, we had but to resort to this summary method of evaluation. We have, however taken care to see that bias, if any, of this method tends towards under-valuation and not over-valuation. In substantiation of our claim, we cite the results of Dr V. V. Sayana's investigations in some of the districts of Madras—a State where land values tend to be relatively low. In 1945, land values in Madras ranged from Rs 350 to Rs. 1,000 and from Rs. 650 to Rs. 2,500 per acre for wet land. *Readings in Rural Problems* (1950), p. 55.

⁴ The percentages are derived on the strength of some information regarding the distribution of land among holdings of various sizes given in the Annexure to Chapter XII of the First Five Year Plan. On the strength of the land values assumed by us, all dry land holdings over 20 acres in area and wet land holdings over 10 acres in area would be valued at over Rs. 10,000.

	<i>Area</i> (<i>Million acres</i>)	<i>Valued at</i> (<i>Rs. per acre</i>)	<i>Total Value</i> (<i>Rs. million</i>)
Single crop land	86.4	500	43,200
Double crop land	14.4	1,000	14,400
TOTAL			57,600

Houses: The total number of rural houses was put at 54.1 million in the 1951 Census. The current capital value of these houses has been assessed by the National Income Committee at Rs. 27,210 million.¹ Obviously, not all of these houses could be treated as belonging to persons with capital assets (which in this case consist primarily of land) valued at over Rs. 10,000. About 20 per cent of the total value of rural houses is taken by us to represent the part owned by this class of persons.² The value of rural houses to be included in our estimate, therefore, is:

20% of Rs. 27,210 million, being the	(<i>Rs. Million</i>)
value of rural houses owned by persons with capital over Rs. 10,000 in value.	.. 5,440

Cattle: The total cattle (including buffalo) population of India was estimated in 1951 at 195 million. Of this, less than five million are kept in the urban area, and the rest are in the rural parts of the country. About 5 million of the cattle are classified as totally unserviceable (i.e. they are too weak or old to render any productive use but they continue to exist). We assume that 30 per cent (i.e. the same percentage as for single crop land) of the total serviceable cattle in rural areas belong to persons with capital exceeding Rs. 10,000 in value. As for their valuation, the problem is nearly as complicated as for land, and the adoption of any one average for the entire country is fraught with extreme limitations. Following the practice adopted by the National Income Committee we have, on the strength of the purchase and sale values given in

¹ Final Report, p. 101.

² According to the National Sample Survey's Report on its second Round, nearly 33.4 per cent of the cropped area in the country was held by 5.3 per cent of the rural households occupying land over 25 acres in area. (The proportion in regard to area is somewhat higher than the one derived by us from the data given in the First Plan). The proportion of houses owned by this class of landowners may not be as high as for land but in terms of the capital value of houses owned the proportion will certainly be higher than their numerical proportion, firstly because they must be living in better and, therefore, more valuable houses and secondly they may be owning houses rented out to others (mostly tenants and landless labourers).

the Report on the Poona Schedules of Sample Survey, assumed a price of Rs. 150 per each adult animal and of Rs. 50 for each calf.¹ The value of cattle to be included in our estimate works out to:

(Rs. million)

30 per cent of Rs. 23,220 million² being the total value of cattle (including buffaloes) owned by persons with capital exceeding Rs. 10,000 in value. 6,970

Total Rural Capital: The aggregate value of the total private capital in the rural sector under the above three heads adds up to Rs. 70,210 million, i.e. Rs. 70,000 million in round figures.

CAPITAL IN THE URBAN SECTOR

As stated earlier, a different method has to be adopted for the estimation of private capital in the non-agricultural sector of the economy. The Central Board of Revenue publishes every year some information regarding incomes charged to income tax. We have taken the income figures for 1953-54, the latest year for which figures are available, as the basis of our calculations. Total income assessed to tax during 1953-54 was Rs. 7,900 million. Of this, salaries accounted for Rs. 1,850 million and company income Rs. 2,200 million. The income from salaries is being excluded from our calculations on the assumption that salaried incomes have little or insignificant capital base. This assumption may not be correct for all salaried incomes but to the extent that it understates the capital base for incomes as a whole, it offsets the overstatement of capital base in the case of the non-salary incomes with inadequate capital base. With regard to company income, there is a suspicion that the portion which is distributed in dividends is already included in the income figures given for individual assesseees. As regards the undistributed portion of company income, it does not usually reflect itself directly and immediately in capital values. Therefore, the entire company income of Rs. 2,200 million is being left out of account.

The balance of income taken into account amounts to Rs. 3,900

¹ The National Income Committee assumes an average price of Rs. 200 per animal in calculating the value of annual increment to livestock. This appears to be rather high. Our prices seem to accord better with the price data published in the Marketing Reports as also in the Reports of the National Sample Survey.

² Represents the value of the total cattle and buffalo population in rural India.

million. In order to work out the corresponding capital base for this income one could adopt either of the following two methods. One could apply a straightforward multiplier, on certain assumptions of course, to the entire income and arrive at a lump-sum figure. But this would not give us any idea about the distribution of property among different property groups—an information which is very essential to have for an appropriate application of a progressive rate schedule. The second method serves to fulfil this requirement. An attempt has been made to reconstruct the likely distribution pattern for property-owning persons in the non-agricultural sector. The results are given in the accompanying table. The calculations in the table are based on the information available in regard to income. It will be observed that in relating income groups with property groups there is no uniform correspondence. This is so, firstly, because income groups in respect of which information is available can be fitted in only very roughly with the property groups in our rate schedule; secondly, we have deliberately not adopted a uniform rate of capitalization. The rate at which income has been capitalized rises from 5 for incomes up to Rs. 25,000 to 20 for incomes of Rs. 1,50,000 and above. These differential rates of capitalization have been adopted on the assumption that the lower the income the smaller the element in it based on property. While this assumption may be agreed to in general, the actual rates adopted here are open to dispute. The element of guesswork is admittedly very high and could be rectified only if more information on property holdings were forthcoming. The error, if any, would, however, be of understatement. The maximum rate adopted for the capitalization of incomes over Rs. 1,50,000 is 20. At the current rate of discount the capitalization rate should be about 30. Allowing for the fact that 75 per cent of income at this level is based on property (this is the proportion prevailing in the U.K. for income at this level) the capitalization rate should be 22·5 as compared to our rate of 20. As regards various other factors which should normally be taken into account for the capitalization of incomes from property, the fact that a very large portion (about 80 per cent) of incomes in company enterprises is not distributed and does not figure in individual incomes should more than compensate for them. We have excluded the entire company incomes from our income-base for the calculation of capital holdings.

The total amount of capital owned by the persons who are paying income tax has been estimated to be about Rs. 32,000

TABLE 1

DISTRIBUTION OF CAPITAL OWNERSHIP IN INDIA AMONG INCOME GROUPS
CHARGED TO INCOME TAX

<i>Income Groups</i> Rs.	<i>Corresponding Capital-ownership Groups</i> Rs.	<i>Annual Income Assessed to Tax in 1953-54</i> Rs. million	<i>Rate of Capitalization</i>	<i>Amount of Capital held</i> Rs. million	<i>Number of persons hold Capital</i>
4,000-10,000	10,000-50,000	1,030	5	5,150	168,400
10,000-25,000	50,000-1,00,000	1,180	5	5,940	81,700
25,000-40,000	1,00,000-2,00,000	490	7.5	3,675	16,700
40,000-55,000	2,00,000-4,00,000	255	10	2,550	5,800
55,000-85,000	4,00,000-8,00,000	270	12.5	3,375	4,400
85,000-1,50,000	8,00,000-15,00,000	225	15	3,375	2,300
1,50,000 and above	15,00,000 and above	395	20	7,900	1,400
				31,965	

million. As for persons whose incomes are below the exemption limit for income tax but whose capital assets may be large enough to become liable to the annual capital tax¹ with an exemption limit of Rs. 10,000, no income figures for the year 1953-54 are available. On the strength of the data available for the war-period, when the exemption limit was lower at Rs. 2,000, it has been estimated that a sum equal to about 20 per cent of the total non-salary income of the individuals liable to tax in 1953-54 can be taken to represent the income of persons with incomes over Rs. 2,000 but below the exemption limit of Rs. 4,200.² This comes to Rs. 800 million which if capitalized at the rate of 5 gives us a figure of Rs. 4,000 million to represent capital value owned by this group.

Total Urban Capital: Thus the aggregate value of the private capital in the urban sector likely to be covered by the annual capital tax amounts to Rs. 36,000 million.

HOARDED GOLD

An important item of private capital which has not been covered by the foregoing estimates is hoarded gold. However, there is little evidence on which one could rely for some sort of estimate for this class of capital assets. In the Bombay Plan it was suggested that the value of hoarded gold in India might be in the region of Rs. 10,000 million at the pre-war bullion prices. If we assume that nearly 50 per cent of the hoarded gold belongs to persons who will become liable to the annual capital tax, the figure of total capital privately owned and taxable can be raised by another Rs. 15,000 million at the current bullion prices. (The assumption of 50 per cent would not appear misplaced if viewed in the con-

¹ As for those persons whose income may be large enough to be taxed but whose capital assets are below the exemption limit fixed for the annual capital tax, we have already made the necessary adjustment by excluding income from salaried jobs and professions

² Between the years 1939-40 and 1947-48, the exemption limit for income tax was Rs. 2,000. Income figures for this period show that total income in the range of Rs. 2,000 to Rs. 4,000 from sources other than salaried jobs and professions was about 20 per cent of the total taxable income of individuals in the first year of the war but it fell to around 12-14 per cent in later years. This might indicate a trend towards the concentration of income-increase of the war-period in higher ranges as a consequence of inflation. But this might as well be due, at least in part, to the difficulty in keeping track of the increase in small incomes as a consequence of which most of the increase in lower ranges went unrecorded in tax returns. The proportion in later years, it is felt, should be higher than 12-14 per cent.

text of concentration of capital ownership. In the U.K., according to the latest estimates by Miss Kathleen Langley published in the Bulletin of the Oxford Institute of Statistics for December 1950, 3 per cent of the adult population owns about 60 per cent of private property. Concentration in India at its present stage of economic progress and with hardly any taxation that impinges on capital ownership would, if not greater, be at least of the same order as in the U.K.). But the unearthing of hoarded gold will be an extremely problematic affair and it is very doubtful if an annual capital tax would be able to bring any significant part of the hoards within the tax net in the first few years of its introduction. Measures will be necessary to ensure not only that new hoards do not go underground but also that the old hoards are brought to light.

ESTIMATE OF YIELD

It is proposed to calculate the prospective yield of the annual capital tax in India in three stages. First we calculate the yield in respect of capital owned in the non-agricultural sector by persons paying income tax. It is in respect of this group of property owners that it has been possible to build up the possible distribution pattern and it is to their capital therefore that the progressive rates can be appropriately applied. Revenue from this part of capital, calculated on the slab system at rates suggested in the text, comes to Rs. 210 million, which is about 0·66 per cent of the total capital charged to tax. Next is calculated the yield on that part of capital in the non-agricultural sector whose owners are not paying income tax. Their capital was estimated at Rs. 4,000 million, and since the rate applying to the lowest property group is 0·20 per cent the revenue from this class of property owners would be around Rs. 8 million. Finally, we come to the property owners in the agricultural sector. The total capital owned in this sector by persons who are likely to be covered by the tax is estimated at Rs. 70,000 million. But the pattern in which this capital is distributed is difficult to find out on the strength of the available data. If it were assumed that distribution in the agricultural sector would be of the same pattern as in the non-agricultural sector for persons paying income tax, revenue from this capital should amount to Rs. 460 million. But the assumption made is a questionable one. It is doubtful if the general disparities among the landowners are as great as in the non-agricultural sector. A less disparate distribution should

mean less revenue. Still, the most extreme assumption of the entire agricultural property belonging to the lowest group of Rs. 10,000-Rs. 50,000 would yield revenue of Rs. 140 million. It would not be far from being realistic however, to put the revenue figure from this class of capital at Rs. 300-350 million. No credit is proposed to be taken for receipts in respect of tax on hoarded gold (which may eventually form a good proportion of the total receipts from an annual capital tax). Thus the estimate of total yield comes to Rs. 520-570 million a year, which is nearly as high as the present receipts of the land revenue from all over India, or of the general sales tax.

PART III

A CRITIQUE OF INDIAN ESTATE DUTY

CHAPTER 8

GENERAL OBSERVATIONS ON THE ESTATE DUTY IN INDIA

IN India the estate duty became payable on the capital value of all property passing on the death of any person on or after 15 October 1953. The Indian estate duty is a simple mutation duty charged according to the value of property changing hands on death irrespective of its destination and without taking into account the distribution of the property among the beneficiaries. In this respect, it is comparable to the single, unified duty leviable in the United Kingdom since 31 July 1949. Till recently, there were as many as seven different death duties on the British Statute Book. But only three of them, namely, estate duty, legacy duty, and succession duty, were effectively operative since 1914. As from 31 July 1949, only the estate duty remains payable and the other two have been abolished. In many other respects as well, the law relating to the estate duty in India is modelled after its counterpart in the U.K., and not infrequently do we refer to the British law and practice on most of the issues tackled in this and the following chapters. Where possible, comparison has been extended to other countries as well. The practices obtaining in other countries of the British Commonwealth, with their imprint of the British forerunner, have served as particularly useful comparisons on some points.

FEDERAL-STATE DEMARCATION OF THE FISC

The Constitution of the Republic of India divides responsibility in regard to the imposition and collection of death duties between the Central government and the State governments. The Central government can impose death duties in respect of property other than agricultural land and the States have title to impose death duties on agricultural land only. The main reason which prompted this type of demarcation was probably historical. For over half a century, the general devolution of functions from the Central government to the States had followed a certain pattern. One of the main features of this pattern was a gradual withdrawal of the Centre from the sphere of agriculture. It was perhaps considered as a natural corollary of this functional distribution of authority between the Centre and the States that all revenue emanating

from agriculture should be assigned also to the States. But it was not just that.

Very early in the process of devolution, the land revenue was assigned to the States, then known as Provinces. The Central Government, however, retained to itself the power to impose and collect the general income tax, although it undertook to allocate a part of its proceeds to the States. When the income tax was first introduced in 1860, incomes from agriculture also were covered, and when this tax was subsequently replaced by a license tax, the agricultural incomes were assessed to a corresponding burden in the shape of a cess. It was, as is pointed out by the Indian Taxation Enquiry Committee of 1924-25, the continued existence of this corresponding burden (in the form of a cess on agricultural incomes) that was responsible for the exemption of agricultural incomes from the purview of the Act of 1886 which reintroduced the income tax.¹ Since then the income tax has gained a permanent footing in the Indian fiscal system. Although the cess on agricultural incomes was removed in 1905-06, the Central government did not extend the scope of the income tax to agricultural incomes. Later in the day, when the continued exemption of agricultural incomes from the income tax was seriously questioned, the process of devolution had gone far enough. Even if the taxation of agricultural incomes was desirable, it was a source of revenue to which the States seemed obviously entitled. Any argument in favour of assigning its administration to the Central government was countered by the assertions that the States were much more qualified to tackle agricultural incomes through their land revenue administrations² and that because of the expanding expenditure needs of the States, they deserved to be assigned all the new sources of revenue, especially those which they could best administer. Once the latter argument was accepted and taxation of incomes from agriculture assigned to the States, it almost followed as a matter of natural sequence that death duties on agricultural land also should be entrusted to the States.³

¹ Report, Vol. I, p. 212.

² This is how the Percy Committee on Federal Finance justified the devolution of tax-power in respect of agricultural incomes to the Provinces (designated as States under the post-Independence Constitution). Report (1932), Cmd. 4096, p. 16.

³ The Percy Committee which was responsible for suggesting this bifurcation of tax-powers in regard to death duties seem to have considered it so obviously

The Government of India Act of 1935 assigned death duties on agricultural land to the States and on the rest of property to the Central government. The same provision has been incorporated in the new Constitution. Now this demarcation in regard to death duties has meant an assignment of functions and not of finance, because the net proceeds of death duties imposed by the Central government are supposed to be reallocated to the States. The Central government is only to impose and administer them. The Central government may, however, increase these duties by a surcharge which can be appropriated by it in its entirety.

The constitutional position being what it is, the bifurcation of the fiscal administration of death duties on the above basis must inevitably lead to differentiation between agricultural and non-agricultural properties, unless the States gave up their title in favour of the Centre. The Centre took the initiative in asking the States if they were prepared to move their respective legislatures for this purpose. It is heartening to note that the majority¹ of States have agreed to surrender to the Centre the authority to impose death duties² on agricultural land. The proceeds of these duties will, of course, be reallocated to the States. Where the States retain to themselves the right given to them under the Constitution, divergences are likely to crop up between the Central duties and the duties levied by such States, whether it be in the matter of rates and coverage or in administration.

The estate duty recently introduced by the Central government could, for reasons explained above, do nothing but except from its purview agricultural land in the recalcitrant States. But, unlike the Central income tax which does not take into account a taxpayer's agricultural income for fixing his income-tax liability, the estate duty does include the agricultural land situated in such a State in the estate of a deceased for determining the rate at which the duty would be payable on property other than agricultural land. This provision has two things to be said in its favour. Firstly, it would not permit an estate owner to tamper with the progressive character of the duty by holding any part of his estate in the form of agricultural land; and, secondly, it called for that no explanation was given in its Report to support this recommendation.

¹ It is believed that all the States excepting Travancore-Cochin have by now given the necessary authority to the Centre.

² It is presumed that the authorization is in respect of all death duties and not the estate duty alone.

will encourage even the recalcitrant States to avail themselves, on their own, of an evident source of revenue.¹

A DIGRESSION

The Constitutional provisions relating to death duties highlight an interesting trend in the thinking of the constitution-framers in India both before and after Independence. The idea running through these and similar provisions relating to other taxes is that the States should as far as possible, be made financially independent of the Centre in order to put their autonomy within the spheres assigned to them on a secure basis.² Such an attitude was perhaps justified in the pre-Independence era when the process of self-government was far more advanced at the Provincial level than at the Centre. But, to adopt the same viewpoint after Independence overlooks the fact that the very autonomy of the constituent units, if carried too far, might easily give rise to conflicting economic and social policies which may stand in the way of the country's economic development. One has only to go through the list of subjects intimately connected with the economic life of the community, which come within the exclusive jurisdiction of the States, to realize the extent to which any unified programme for the economic development of

¹ In the U.S.A., the federal estate duty allows a tax credit or offset of up to 80 per cent of the federal duty payable under the basic rates fixed in 1926 for meeting the death duties levied independently by the States. This encouraged a number of States to introduce or to raise their duties so as to secure this obvious source of revenue. The provision in regard to agricultural land in the Indian estate-duty law will also, it is felt, induce the recalcitrant States not to leave such an obvious source of revenue untapped. But as the American experience has amply shown, this need not lead to uniformity of tax-legislation and tax-administration as between the States and the Centre.

² The Joint Select Committee of the Houses of the British Parliament (1917-18) made it a cardinal principle of their proposals for constitutional reform in India, that the provinces (now called 'States') be given the largest measure of independence of the Central government. And to that end it suggested that, 'if the provincial autonomy is to mean anything real, clearly the provinces must not be dependent on the Indian Government for the means of provincial development.' As to the division of revenues, the despatch of the Government of India (No. 13 of 1922) said emphatically that 'a clear division of revenues between the Central and Local Government was the basis of the whole scheme of reforms, and we consider it axiomatic that unless such a division is made, and entirely separate sources are secured to each government, there can be no provincial autonomy in any sense of the term.' Quoted in Gyan Chand's *The Financial System of India*, London, 1926, pp. 152 and 174.

the country as a whole could be baulked by the separatist policies of the State governments. It is encouraging to note that in spite of the permissive provisions of the Constitution, the States decided to put their heads together with the Centre in the drawing up and in the implementation of a unified programme of economic development, known as the First Five Year Plan. Technically, any State could stand apart. But none did. Very probably because every State stands to gain, though in varying proportions, from the additional resources made available by the Central Government apart from the statutory transfers required to be effected in accordance with the Constitution.¹ Whatever be the underlying motives, it is not too much to hope that new and better conventions will grow up in the course of this concerted effort directed towards the country's economic development which will make unnecessary the constitutional provisions laying down a rather inflexible and somewhat separatist code of behaviour as between the Centre and the States.

¹ The fact that the Central government has direct and exclusive control over the creation of currency and credit (the latter is exercised through the nationalized Central Bank) in the country lends it a power of finance without compensating provisions in the Constitution in favour of the States. In addition, the Centre can exercise restrictive supervision on the borrowing activities of the States. Because of all this, the States have to depend on the Centre whenever they intend resorting to deficit financing. The importance of this factor can well be assessed from the fact that in the first three years of the Plan (i.e. from 1951-52 to 1953-54) the Central government gave Rs. 1,223 million to the States in the form of 'non-statutory' loans and grants and during this very period, the Centre's overall deficit amounted to Rs. 1,117 million. (Figures obtained from the First Five Year Plan's Progress Report for 1953-54, p.30).

CHAPTER 9

AGGREGATION OF ESTATES AND EXEMPTIONS

ALL property passing, or deemed¹ to pass, on the death of a person has to be aggregated for the purposes of the estate duty. This need for aggregation, as is well known, arises because of the progressive nature of an impost. If the duty were levied at a uniform rate, the need for aggregation would not arise. But, not all the property passing on death is chargeable to the estate duty. Under the Indian Estate Duty Act certain types of property are exempted from tax. But the exemption allowed is operative in two different ways. There are (a) cases in which property is exempt from duty but has to be aggregated with the rest of the property chargeable to duty for determining the rate; and (b) cases in which property is neither chargeable to duty nor included in the aggregate.

AGGREGABLE EXEMPTIONS

One of the cases covered in the first category was discussed in Chapter 8. Agricultural land in the States, which do not delegate to the Central government the power to impose the duty on their behalf, is not chargeable to the Central duty but it has to be aggregated with the rest of a deceased's estate to fix the rate at which the duty becomes payable. Another exemption in this category relates to small gifts *inter vivos*. Gifts given away within a certain period before death are ordinarily liable to the estate duty. But such gifts are exempted if their value does not exceed Rs. 2,500 when made for a public charitable purpose and Rs. 1,500 for any other purpose. In the U.K., there is one exemption limit for all types of gifts *inter vivos* (other than gifts of settled property) belonging to this category. Where in the case of any donee, the aggregate amount of a gift made to him by the deceased does not exceed £500 (i.e. Rs. 6,670) in value, it does not attract the estate duty. The Indian law does not make it clear

¹ Ordinarily, property passing long before death is not chargeable to duty, but in certain circumstances, it is deemed under the Act to pass on death and is therefore chargeable to duty.

whether the exemption applies to the aggregate of all the gifts made by the deceased within the prescribed period before death, or, as in the U.K., to the aggregate of the gifts made by a deceased to any one donee. Perhaps, the intention is to follow the British practice, but the matter could have been put in a less vague form. In Ceylon, the law explicitly exempts from estate duty gifts totalling not more than Rs. 1,500 in value made to any one donee.

The more important difference, however, between the Indian and British laws on the subject is in regard to the aggregation of the exempted gifts with the rest of the estate passing on death for the fixation of the rate of duty. The British law exempts such gifts from aggregation and the Indian law does not. On principle, the approach adopted in India has something to be said for it. One may justify the exemption of small gifts on the plea that these gifts tend to redistribute property and that they usually go into deserving hands, i.e. persons who need to be uplifted in economic terms, but there is no reason why because of the operation of this exemption the rest of the estate should be made to bear less tax burden than it would in the absence of these small gifts.

RULES REGARDING INSURANCE POLICIES

The other case, in which the property is not chargeable to duty but is aggregable, is that of

- (i) insurance policies effected by the deceased for the purpose of paying the estate duty; and
- (ii) deposits with the government for the purpose of paying the estate duty.

Exemption is admissible in this case up to the amount of duty payable provided that such an amount does not exceed Rs.50,000. The British estate duty does not make any exemption of this nature, nor does the estate duty in other countries of the British Commonwealth. Insurance policies effected for the payment of estate duty or deposits made with the government in anticipation of the liability are not only aggregable but also liable to tax in the U.K. and other Commonwealth countries excepting India. The underlying purpose of the Indian government in providing for this exemption is a matter for speculation. The purpose might be to induce greater saving on the part of the estate-owners; for, after all, emphasis is being put at present on larger saving in the economy so that investment can be speeded up without inflation.

To some extent, the payment of death duties has a dampening effect on the incentives to save. This disincentive effect may be said to operate in so far as the desire to bequeath property is a motive which actuates the building up of fortunes. The above concession operates in favour of saving because any amount kept in the above form (i.e. in insurance policies or deposits with the government) will not attract the estate duty when an estate passes on death. To illustrate the point, let us assume that with a given level of the estate duty a person decides to save at a certain rate out of his income on the reckoning that at this rate he will be able to leave a certain amount of property on death. He is not prepared to save at a higher rate because he thinks that the satisfaction he derives from the amount consumed by him is greater than the satisfaction he derives from the thought of being able to leave behind the additional amount, net of duty payable, on death. Now, the law is amended to say that the amount deposited with the government, or kept in insurance policies for the purpose of paying the estate duty will not be liable to duty. This means that any additional amount saved and kept in the above form will not attract duty although it may lead to a somewhat higher rate of duty on the rest of the estate because of the aggregation of the former with the latter for rate determination. The fact that the additional saving has to be kept in a particular form is not important because the amount saved in this form only replaces what would otherwise be taken out of the rest of the property for paying the estate duty. The other effect of this concession might be institutional. It will encourage the growth of this new type of insurance business in the country. Insurance policies are likely to be more popular than deposits with the government because they combine tax exemption with life insurance. The government in India could, of course, undertake this sort of insurance work itself, and utilize it as a channel of attracting saving from the private sector.¹

The Indian estate duty gives still another concession to insurance policies in exempting from its charge 'moneys payable under one or more policies of insurance effected by the deceased on his life, to the extent of rupees five thousand.'² The

¹ The First Five Year Plan did refer approvingly to State participation in insurance business, and had suggested a close examination of 'the precise steps to be taken in enlarging State participation in this sphere.' See 'The First Plan'. p. 68.

² Section 33 (1) (h) of the Estate Duty Act, 1953.

arguments in favour of the exemption of life insurance from death duties are very old. The burden of such arguments has been that the taxation of insurance policies at death (that is, when life policies, and also endowment policies in the case of premature death, become payable) makes people unwilling to insure. It is usually overlooked that insurance is primarily 'one among many ways in which individuals may save.' The Colwyn Committee on National Debt and Taxation (1926) was averse to any relief in favour of insurance policies. It was their view that if there was some justification for special consideration in favour of insurance as a means by which the less wealthy taxpayer secured a proper provision for his dependants, the relief already allowed in the income tax amply provided for it. The Committee's viewpoint has been accepted in the U.K. and no relief is given in death duties in respect of insurance policies. In most other countries also insurance money is included in the taxable estate. But in New Zealand policies of life insurance not exceeding £1000 (Rs. 13,333) in aggregate, and in Pakistan policies not exceeding Rs. 20,000 in aggregate, are not chargeable to the estate duty. However, while in India and New Zealand the insurance policies thus exempted are aggregable with the rest of the property for the fixation of rate, in Pakistan it does not appear to be the case. Thus in Pakistan the taxpayer may gain not only on the life insurance money, but also on the rest of the estate by qualifying for a lower rate of duty.¹

As regards the general question of exempting life insurance policies to rectify the disincentive effect of death taxation on people's willingness to insure, one may concede that in the U.K., when all estates over £100 in value were to pay death duties, the insurance money being too obvious to conceal from the notice of tax authority might not have appealed to 'the less wealthy' classes as a means of saving. And, if they did not save to insure, they might as well spend instead of keeping their saving in any other form. For estates of higher value, insurance usually happens to absorb only a part of an estate and it seems doubtful if total savings of this group of estate-holders would be significantly affected just because insurance money is easily identifiable for purposes of taxation. Of course, an exemption from tax in favour of the life insurance may encourage estate-holders

¹ This does not hold true beyond the point in the rate-scale where the rate ceases to rise with the rise in the value of the estate.

to insure for higher amounts and there may also be some net gain in total savings. But why should insurance be given any advantage over other forms of saving? So long as insurance business is in private hands¹ and there is no public control in the canalization of its funds, is there any justification in giving it this indirect subsidy? Answers to these questions will take us away from our subject. But, a government must take them into account, when it decides to take a step like the one under consideration. As to the effect on actual savings, the effectiveness of the present Indian measure is open to strong doubt. For, even for a borderline estate over Rs. 100,000 in value, the life insurance exemption would apply to less than its 20th part, and the proportion will fall with the rise in the value of the estate. Would it not smack of over-optimism to conceive of any significant rise in the savings of the dutiable class in India because of the operation of the above exemption?

The estate duty in India also exempts from its charge moneys earmarked under policies of insurance or settlements effected by a person for the marriage of any of his female dependants to the extent of Rs. 5,000 for each such dependant.² This exemption also belongs to the first category under the classification made by us earlier (i.e. the cases covered by it are not aggregable). This exemption is defended on social considerations. The family, as an institution, is a very important social unit in India, and marriage commitments in respect of female dependants are, no doubt, a sort of binding liability on the male members of a family. It is therefore quite proper to treat such commitments, within reasonable limits, as not only non-dutiable but also as non-aggregable. In this respect, however, the law in India seems to draw an unjustified distinction between policies earmarked or settlements effected in consideration of marriage and gifts made in consideration of marriage. Gifts of this type when made within the specified period before death are treated as non-aggregable as well as non-dutiable, provided they do not exceed Rs. 5,000 value. But policies and settlements with a similar purpose in view are aggregable even though they are exempted from the payment of duty. The appropriate thing to do would be to make

¹ Since this was written, life insurance has been taken over by the government. But, it is very doubtful if this provision in the estate duty law was based on any prescience of the later measure to come.

² Section 33 (1) (k), Estate Duty Act, 1953.

the gifts also aggregable, for non-aggregation confers no benefit on the donee, whose interest it is intended to protect.

NON-AGGREGABLE EXEMPTIONS

The second category alluded to above refers to those items of property which are neither dutiable nor aggregable for purposes of estate duty. The estate duty in India exempts household goods including tools of trade to the extent of Rs.2,500, wearing apparel excluding precious stones and ornaments, and books and works of art not intended for sale. The estate duty in the U.K. gives similar exemption only in respect of those books and works of art 'which are of such national, scientific, historic, or artistic interest that they would be purchased or accepted as a gift or bequest by one of the national collections.'¹ Ordinarily, these articles are exempt if they are given over to any of the public institutions or are retained in the family. If the articles retained in the family are sold to other than 'national collections', they become chargeable in connexion with the last death on which they passed. The Indian duty is more liberal in its application, because it covers all books and works of art provided they are retained in the family and 'are dealt with or disposed of in accordance with such conditions as the Board² may prescribe and are not intended for sale.'³

TREATMENT OF PROPERTY HELD ABROAD

Closely connected with the issue of aggregation is the treatment accorded to property held abroad. Both the Indian and British estate-duty laws agree in their treatment of such property. All movable property held abroad is dutiable and aggregable and all immovable property so held is neither dutiable nor aggregable. Now, it is in the case of immovable property held abroad that the criticism levelled earlier in this chapter in regard to the non-inclusion of small gifts in the aggregate estate can be invoked. To exclude foreign immovable property from the payment of estate duty is defensible because no government would agree to exonerate tangible property located physically within its territorial jurisdiction from its own taxes because it is owned

¹ Dymond, R., *The Death Duties*, 10th edn. (1946), p.198.

² Stands for the Central Board of Revenue in India.

³ Section 33 (l) (i) and (j), Estate Duty Act, 1953.

by a foreigner.¹ But to allow a person to have immovable property, held outside the country of his domicile, exempted from aggregation for purposes of fixing the rate of duty, is to provide for a mode of asset-composition which enables him to reduce his tax burden not because the property held abroad is exempted from tax (although differences in tax rates between countries give opportunities of this type as well), but because the property locally held is liable to pay duty at a rate lower than that which would be applicable if the entire estate (i.e. foreign plus local) were held locally.

While no statistical study is known to have been made of the magnitude of capital transfers induced in this way, it would be unwise to ignore the scope which exists for tax-avoidance. An Indian with a non-agricultural estate of Rs. 150,000 will have to pay in India Rs. 2,500 as estate duty, but if he invests Rs. 40,000 in Britain, say, in a house, he pays only Rs. 500 in all. No duty is payable in Britain because his estate in that country falls below the prescribed exemption limit. Now this will not happen on a large scale between India and Britain because of the lower exemption limit and higher rates of duty in force in Britain. But this could happen between India and say, the U.S.A., because in the latter country the exemption limit is about thrice as high as in India and the effective rates are lower over a fairly wide range.²

Existence of effective control on transactions in foreign exchange (including movements of capital) does restrict considerably the scope for this type of tax-avoidance. It could be argued that in her present phase of economic development, when conservation of foreign exchange is of prime importance, it would be unrealistic to visualize a relaxation of exchange control in India. It is,

¹ J. C. Stamp puts it somewhat differently: 'The physical property where situated is located and taxed, the intangible is assessed and taxed to the owner where he resides, both on the legal theory that personal property follows its owner and on the economic theory that the person owes tax allegiance to the place where he lives.' *The Fundamental Principles of Taxation* (1936), pp. 132 & 3. In his evidence before the Royal Commission on Income Tax (1920) he divides tax-obligation into two parts: (i) that due for specific protection and maintenance of particular sources of income, and (ii) that due for privileges which the citizen enjoys in his person and residence. It is on the latter score that he asserts that 'no one would admit that the English resident should be free from all obligation to the British Government merely because his income is derived from abroad.'

² For a married person leaving behind his estate to the surviving spouse, the rates are lower over the entire scale.

therefore, true that in spite of the above defect in the estate duty law in India substantial movement of capital to other countries may not take place in the existing conditions. But the possibility of leakage and its effects on the economy cannot be overlooked under less stringent control on foreign exchange. In Ceylon, this loophole is plugged by a distinction that is drawn between a deceased's 'total estate' and 'Ceylon estate'. 'Total estate' covers all property wherever situated, and 'Ceylon estate' includes all property except immovable property held outside Ceylon. The duty is then charged on the value of the 'Ceylon estate' at the rate payable on the value of the 'total estate'.¹ In Canada also, the initial duty (which in its features resembles estate duty) is payable on the 'dutiabale value' of an estate at the rate fixed with reference to the 'aggregate net value' of the estate, which covers all property of the deceased wherever situated, after debts and incumbrances have been allowed for.² There is, in our view, every reason for adopting a similar procedure for charging estate duty in India so as to eliminate any possible strain on the capital resources of the country.

¹ Estate Duty Act of 1937, Part I.

² J. H. Perry, *Taxation in Canada* (1953), pp. 100-117.

CHAPTER 10

RELIEF FOR IRREGULAR SUCCESSION

FOR a long time, death duties have been objected to because of the iniquitous treatment resulting from irregular occurrence of deaths. This objection has been met in most of the legislations on death duties by some sort of graduation with reference to the frequency of their collection. In the U.S.A., the federal duty is not leviable on an estate passing on second death, if the second death occurs within five years of the first. In Germany, relief used to be confined only to certain categories of beneficiaries. But unlike in the U.S.A., it did not concede any total exemption from duty on the second death, however close in time to the first death.¹ In the U.K., Canada, Ceylon, New Zealand and Pakistan, the respective laws on death duties authorize reduction in tax liability on a scale graduated inversely to the time-distance between the first and second deaths. The scale² of relief is the same for these Commonwealth countries and that now adopted in India. But in the U.K., Ceylon and Pakistan, this relief is admissible only in respect of landed or business property which passed to the second deceased on the first death. In Canada and New Zealand however, this very scale of graduated relief applies to all identifiable estate passing on a second death within five years of the first death. In India also this latter procedure

¹ Under the German Inheritance Tax of 1919, if any beneficiary of classes I, II or III died within five years, 50 per cent of the movable and 100 per cent of landed properties were exempted from the second tax; for second death occurring after five but within 10 years, 25 per cent of the movable and 50 per cent of landed properties were exempted. Moreover, the tax paid by a widow was to be credited towards that payable by children if she died within ten years and the credit would be 50 per cent if she died within 10 to 15 years. W.J. Shultz, *The Taxation of Inheritance* (1926), p. 93.

² The scale of relief in the U.K., Canada, Ceylon, New Zealand, Pakistan and India is as under:—

<i>If the second death occurred within this time: No. of years.</i>	<i>% Rate of relief.</i>
1	.. 50
2	.. 40
3	.. 30
4	.. 20
5	.. 10

is followed in the grant of relief. Moreover, no estate duty is payable in India in the case of a second death occurring within three months of the first death; also no estate duty is payable on a Hindu widow's estate, if the widow dies within seven years of her husband's death. This provision is comparable to the relief given at one time in Germany for a widow dying within 15 years of her husband's death.

ESTATE-AGE GRADUATION

Adam Smith was perhaps one of the earliest of the writers on the subject of death duties who referred to the infringement of tax justice involved because of 'the frequency of transference not being equal in property of equal value.'¹ Several later writers on this subject also criticized this very aspect of death taxation. Shultz refers in this connexion to what he terms an extreme proposal for the rectification of this defect made by an Italian writer, G. Navarra Crimi:²

'that, thirty-two years being taken as the duration of a generation, the second inheritance tax be reduced by one-thirty-second for each year under thirty-two that had elapsed between the inheritance of property by the decedent and his own death.'

Jacopo Tivaroni of France had, it appears, a similar proposal in mind when he suggested that 'at the death of each heir the State should make a deduction from the tax on his estate for the time he would normally have enjoyed, but did not live to enjoy, whatever inheritances he might have received during his life-time.'³ More specifically, he proposed that 'the inheritance tax, to take into consideration "ability", should be graduated according to the age of the heir, and make allowance for the number of years' expectation, the mortality tables grant him.'⁴

In recent years, there has been a renewal of emphasis on this aspect of death taxes. William Vickery must be given the credit for not only reviving the issue but also for putting forward concrete suggestions to meet it. But his main purpose is not so much to offset the iniquity resulting from the natural irregularity in deaths as to counteract tax-avoidance. 'In the main,' he

¹ Adam Smith, *Wealth of Nations*, Book V, Chapter 2, Appendix to arts.

¹ and 2. Also G. F. Shirras, *Science of Public Finance*, 3rd edition, Vol. 2, p. 533.

² Quoted by W. J. Shultz, *op. cit.* p. 303, note 30.

³ *Ibid.* p. 222.

⁴ *Ibid.*

says, 'succession taxes are assessed without regard to frequency of transfer, and the taxpayer is accordingly under strong pressure to provide for the transfer of his property to the ultimate beneficiaries with as few intervening transfers as possible. Property is accordingly bequeathed directly to children and even more remote heirs in preference to the more normal procedure of transferring property to the widow, children and grandchildren in turn.'¹

Vickery is aware of the Crimi-Tivaroni proposal referred to above.² The logic of this proposal, he says, is that the older the heir, the sooner the property will be taxed again. He objects therefore, that it would produce a strong incentive for the donor to keep the property as long as possible. Tivaroni's suggestion did not, however, overlook this objection. As is clearly indicated in Tivaroni's quotation cited earlier, he had suggested a reappraisal on the death of each heir so that the contingency, which Vickery now foresees, did not arise. Indeed, in a case where the beneficiary consumes the entire bequest during his lifetime there would be the difficulty of having to recover the excess tax, if due on reappraisal. But this difficulty would be more or less of the same nature as tax arrears outstanding on the death of a person. There is not much force therefore in Vickery's assertion that 'it is not easy to see any very clear logic to the proposal where the beneficiary expects to consume the entire bequest during his lifetime.'³

AGE-DIFFERENCE GRADUATION

Since Vickery is dissatisfied with the Crimi-Tivaroni proposal, he puts forward his own scheme for the graduation of tax rates to be based on the difference in age between the testator and the legatee. Although progression of the tax graduated according to age-difference could be based either on the size of the estate or on the size of the succession, he rightly prefers the latter. He combines age-difference graduation with cumulation of successions. In his scheme, therefore, a current legacy or gift received by a beneficiary is added to the sum of all the previous gifts and

¹ William Vickery, *Agenda for Progressive Taxation* (1947), p. 215.

² Vickery is not correct in referring to this proposal as emanating from Shultz. In fact, Shultz describes it as 'an extreme proposal'. He has rather persuaded himself to the belief that theoretically, 'there is little or no justification for inheritance tax rebates when a rapid series of succession occurs.' *The Taxation of Inheritance*, op. cit. pp. 302-305.

³ Ibid. p. 218.

legacies and the net tax currently due is the difference between the tax computed on the new total and the tax computed on the previous total. The tax on both the totals is computed from one of the several schedules selected according to the age-difference involved in the current transfer rather than from a single schedule applicable to all legacies and gifts.

The main difference between Vickery's plan and, what we have decided to call, the Crimi-Tivaroni plan is that while both Crimi and Tivaroni wanted to secure equity in the incidence of death taxation as between different estates by a system of rate-graduation based on the age of an estate (i.e. the period for which it is held by a beneficiary), Vickery's scheme seeks to secure this equity through graduation based on the age-difference between the testator and the legatee. This difference stems from the divergence in the underlying purposes of the proponents of the two plans. Vickery is interested primarily in putting an end to tax-avoidance caused because of the tendency 'to skip a generation', whereas Crimi and Tivaroni were interested in rectifying Adam Smith's complaint regarding inequity in taxation resulting from the 'natural' irregularity in the occurrence of death.

The assumption which appears crucial to Vickery's scheme for the graduation of tax rates according to age-difference is that the difference of age between a legator and a legatee corresponds to the time which an estate normally takes in passing from the former to the latter. This assumption seems to us very arguable. Even in a case where a person transfers his estate straight to his grandson with the deliberate purpose of skipping the intervening transfer, it is not the existing difference in age between the testator and the legatee which is really relevant. To be more specific, if the age-difference between a testator 'A', and his grandson 'C' is 60 years, and the son 'B' comes right in the middle, it is a relationship which gives us no idea as to the time-spacing of estate-transfer on death or otherwise. Let us assume that 'A' dies at the age of 75, and the estate passes as of right, to 'B', who is then 45. Now, in order that the next transfer takes place precisely after another 30 years, 'B' must live on till the age of 75. But, if he dies earlier, the transfer takes place sooner than is assumed under the Vickery plan, but still, at the time of transfer, the age-distance between 'B' and 'C' remains thirty and, therefore, the estate becomes liable to tax under this plan at a rate which would apply even if 'B' were to live longer. Even where 'B' lives on till 85 (i.e. for 40 years after inheriting the said estate from 'A')

the difference between him and 'C' in age would still be 30 years. Thus, under Vickery's plan the estate will be charged at the same rate when it passes to 'C' whether the beneficiary 'B' had held it for 10, 20, 30 or 40 years. If we revert to our original case where 'A' transfers his estate straight to 'C', the estate will, under this plan, be charged according to the rate applying to age-difference of 60 years, although the actual distance in the event of regular transfers as from 'A' to 'B' and from 'B' to 'C' might (in this example) be anything from 40 to 70 years.

Vickery's whole plan, it will be observed, is based on the question-begging assumption that the age-difference between the testator and the legatee represents the time for which the latter is likely to hold the estate before its next transfer. However, Vickery seems to be instinctively aware of the illogicality of his assumption and this becomes evident when he has to apply his plan to the case where the legatee happens to be older than the testator. But he does not discard the assumption. Instead, he suggests that the tax rate in such a case should be very moderate 'if indeed there is occasion for any tax.'¹ Again, when he tries to combine age-difference graduation with cumulation of inheritances, he discovers that 'if such taxes on multiple legacies are computed in the order of their receipt, the total burden may depend somewhat capriciously on the order in which they are received.'² To eliminate this capriciousness he introduces an expensive³ gadget to support his plan. He makes the assumption that the legacies are received in the normal order, i.e. from the older donors first. Vickery's plan becomes in this fashion more and more complex. But, in spite of the laborious details that he works out, the outcome is not very encouraging because one is still faced with the problem which Adam Smith posed about two centuries ago. All that this scheme does is to replace the vagaries of death by the vagaries of age-difference without making the tax-incidence more equitable.

Vickery's plan relies on an inherently incorrect assumption and it must be discarded. Instead, the principle of graduation on the basis of life-expectation with a provision for reappraisal

¹ Op. cit. p. 217. In the table constructed by him at p. 222 of his book, Vickery assumes that in such cases the maximum age-difference would be 15 years.

² Op. cit. p. 222.

³ Vickery refers to the cost involved in terms of 'some increase in the complexity and labour of computing the tax.'

on transfer should serve to eliminate the inequity referred to by Adam Smith. The Crimi-Tivaroni plan has, in our view, the making of a better alternative to Vickery's plan. For it will not only meet the classical objection against death taxes on the score of equity, but also cover Vickery's point regarding tax-avoidance. The life expectation of a grandson will obviously be longer than of a son and since the tax rate will be regulated accordingly, the incentive for 'skipping a generation' would no longer be there.

It might be objected that the alternative plan would be difficult to administer because of the practical problem involved for the purpose of reappraisal in distinguishing the part of one's estate which is due for rebate or is liable to surcharge. But, the problem is not so forbidding as it appears. It is, in fact, not necessary to make a distinction like this if the rebate or surcharge were to be calculated on the basis of the original value of the estate at the time it was inherited.¹ If the descendant lived beyond the estimated period, the estate becomes liable to surcharge, and if he died earlier, the estate becomes due for relief.

QUICK SUCCESSION RELIEF

It is perhaps too early to expect any government, much more the government in India, to overcome the proverbial distrust of a new scheme, however sound it may appear on paper. The scheme referred to above may, therefore, have to wait for some time. In the meanwhile, the governments have, as indicated earlier in this chapter, adopted, on empirical grounds, measures for giving relief in cases where estates become liable to death taxation rather too frequently. It is widely recognized that a rapid repetition of death duties caused by an extraordinary succession of deaths leads to a rapid extinction of an estate which in the normal course would be handed down from generation to generation, tempered, of course, by death taxation.² In the U.K., where relief for quick succession is given only in respect of

¹ This follows the practice already being followed in the U.K., as also in India in the grant of quick succession relief. Section 31 of the Estate Duty Act, 1953 of India reads as follows: 'Provided that where the value on which the duty is payable on the property on the second death exceeds the value on which the duty was payable on the property on the first death, the latter value shall be substituted for the former for the purpose of calculating the amount of duty on which the reduction under this section is to be calculated.'

² W. J. Shultz, *op. cit.* p. 303.

land and business property, the argument adduced is still more empirical. Lloyd George justified this measure because in the case of landed or business property, liquid assets are usually not held in sufficient proportion and death duties 'cannot easily be realized or charged without breaking up either the estate or the property in some shape or form.'

The relief given in India for quick succession is more liberal than in the U.K., Ceylon and Pakistan, in two respects. Firstly, no estate duty is payable on second death if it takes place within three months of the first death, and secondly, the relief is admissible in respect of all kinds of property constituting a dutiable estate under the Indian law. It has, however, been alleged in some quarters in India that the relief given is not adequate. The rate of relief should, it is contended, be higher than in the U.K., because of the higher rate of mortality prevailing in India. It is doubtful if differences in mortality rates between India and the U.K. are really a relevant consideration in this connexion.² Once it is decided that a death duty is to be levied on transfers taking place at death, the differentiation on the score of rapidity in succession should depend on one's view of how rapid a particular succession is as compared to the 'representative' succession—representative in the sense of its taking place within an average time elapsing between the taking over and transfer on death of an estate. And, if the period usually elapsing between two deaths is smaller in India than in other countries, the relative relief for quick succession should, it could be argued, be smaller, and not greater, in India.

¹ Speech in the House of Commons, *Parliamentary Debates (Commons)*, 1914, Vol. LXII, p. 91. Earlier, in 1913, he argued against such relief because it would, *inter alia*, involve loss to the State unless provision was made for charging extra duty 'at the other end of the scale where there elapses more than a generation where the time between the collection of the duty is abnormal.' *Parliamentary Debates (Commons)*, 1912, Vol. XLI, pp. 3106-7.

² Although one may even argue that very possibly the incidence of mortality among the propertied classes chargeable to estate duty in India is not very different from that among similar classes in the U.K. Unfortunately no statistical evidence is available at present to substantiate this contention.

TREATMENT OF GIFTS

TRANSFER of properties takes place either in return for consideration or gratis. The former is a business transaction in which usually one form of asset is exchanged for another. The latter type of transfer takes place without involving such an exchange. Where the case for taxation is argued on grounds of equity, this latter type of property transfer has for long been regarded as a proper object to tax. When a person receives something without having to give something else of equal value in exchange for it, his economic power can be said to have increased and so also his ability to bear taxation. Now, this unrequited property-transfer takes place either during a donor's lifetime or on his death. Lifetime transfer is usually referred to as 'gift', and transfer on death as 'bequest'. Just as in the case of a commodity with composite demand, a change in price in one direction has an effect on supply in other directions, so also is the case here in regard to the taxation of gratis property-transfers. Taxation of one type will affect the transfers in the other direction. The Indian estate duty taxes transfers on death only. We have already observed that this partial measure cannot be justified on the score of equity.¹ In this chapter, it is proposed to discuss how the tax, as it is, will cause people to resort to all sorts of tax-avoidance activities which make its incidence arbitrary and inequitable, and to suggest remedial measures.

Bequests are a form of disposition of property which becomes effective on the testator's death. If there is a tax on bequests and none on the other type of disposition, it is natural to expect a movement away from bequests to the other type in order to avoid taxation. Any government which imposes one or the other type of death duties faces the questions: How are gifts during one's life to be treated for purposes of death taxation? Should they or should they not be aggregated with bequests for taxation on death? If death taxes are to be regarded as a tax on capital levied at intervals (fixed in this case according to the spacing of deaths) it is essential from the point of view of equity that as

¹ See Chapter 7, *supra*.

far as possible the incidence of this tax on capital should be made independent of the channels of disposition.

Provision is usually made in the legislation on death taxation to reduce the scope for tax-avoidance through changes in the form of disposition. The Indian estate duty draws a distinction between two types of gifts: (i) gifts *mortis causa*, and (ii) gifts *inter vivos*. Gifts *mortis causa* (i.e. in contemplation of death), are in the nature of death-bed donations, as distinct from gifts *inter vivos* which are made by a person at any time in the ordinary course of his life. The essential feature of death-bed gifts is that they do not take effect if the donor revokes them before his death, or recovers from his illness, or the donee predeceases him. Being conditional gifts they are deemed to pass on the death of the donor. As regards gifts *inter vivos*, the law in India stipulates two separate time-limits: one for charitable gifts and the other for all other gifts. These time-limits specify the period before death during which all gifts of the respective types shall be treated as transfers on death. The period thus specified is usually referred to as the statutory period. In India, the statutory period is six months for gifts made for public charitable purposes and two years for other gifts *inter vivos*.¹ The idea underlying the fixation of the statutory period is that it is usually some time before one's death that gifts are doled out with the express purpose of avoiding death taxation. If there are variations in time-limits fixed in different countries, they are indicative not so much of the differences in the estimation of time within which gifts are really made with a view to avoid taxation but of their respective willingness (or the lack of it) to clamp down effectively on dispositions of this type. (The arbitrary character of the main idea should however be obvious. While some gifts made within the statutory period may be given with the purpose of avoiding death taxation,

¹ For purposes of comparison, we give below the length of the statutory period for gifts *inter vivos* in other countries of the British Commonwealth:—

Country	Statutory period for charitable gifts	Statutory period for other gifts
U.K.	1 year	5 years
Australia	Totally exempted	1 year
Canada	Totally exempted	3 years
Ceylon	1 year	5 years
New Zealand	Totally exempted	3 years
Pakistan	3 months	1 year
South Africa	Totally exempted	5 years

there may be other gifts made within this period which are genuine gifts given without any such motive.)

Gifts made within the statutory period are, unless specifically exempted,¹ aggregable with the property actually passing on death and are chargeable to the estate duty. But gifts made outside the statutory period are neither aggregable nor dutiable even though it can be established that they were made with the sole objective of tax-avoidance. In the same way gifts made within the statutory period may have been made with no intention of avoiding estate duty, but they will still be taxable as part of the transfer on death. Of course, a gift which is exempted in law must be genuine, that is, a real and genuine transaction intended to operate without any secret arrangements or reservations. To qualify as a bona-fide gift, the law insists that the donee must take immediate possession of the property donated and retain it thereafter to the entire exclusion of the donor 'or of any benefit to him by contract or otherwise.'² Any reservation on the part of the donor renders the gift ineligible for exemption from the estate duty.

Since gifts made outside the statutory period do not attract any duty it seems natural that a tendency will develop on the part of the people to gift away as much as possible of their estate sufficiently early in life. This tendency will be particularly strong with a person in whose case the main motive for saving is provided by the desire 'to hand on accumulated capital to his children after the accumulator's death.'³ Such persons would certainly like to see their capital possessions pass unimpaired to their descendants. And if they can forestall their death by more than two years, they would manage to avoid the impairment which estate duty (in India) would otherwise cause. In fact, in the case of such persons, transfers might start taking place quite early in the donor's life. But there are other persons who build up their estates not primarily out of consideration for their dependants, but for considerations like the desire for power which is usually conferred by wealth, 'the desire for posthumous glory in dying very rich,' or 'the desire for a large income accruing without effort in later life.'⁴ In their case, the tendency to gift away property before

¹ e.g. gifts of the value of Rs. 2,500 for charitable purposes and of Rs. 1,500 for other purposes are exempted from the payment of estate duty.

² Section 10 of the Estate Duty Act, 1953.

³ A. C. Pigou, *A Study in Public Finance* (1947), p. 143.

⁴ Ibid. p. 142.

one's death may not be very strong. They would rather hold on to their possessions till the very last. But even in such cases, the knowledge that the tax could be avoided will serve as a constant source of temptation to gift away the estate.¹ And the temptation is doubly strong when the duty is a progressive tax, because one saves not only in duty on the estate gifted away in time but also in the lower rate of duty applying to the rest of the estate that passes on death.²

The advantages in making donations before the statutory period may, it will be observed, lead to a gradual rise in the number and magnitude of gifts *inter vivos*. No inquiry is, however, known to have been conducted into this aspect of death taxation even in countries where it has been in force for a long time. But it is quite conceivable that before World War II, when effective rates of death duties were, in general, not very high, the inducement offered by tax avoidance was not strong enough to offset 'the reluctance of property owners to part with their own, even to their nearest and dearest,'³ and therefore the magnitude of gifts *inter vivos* gave no cause for concern. However, as the rates have been increased in many countries since the outset of the war, the position, it is feared, may have changed especially where the rise in rates has been as drastic as in the U.K.

The effective rate of the estate duty in the U.K. has risen from 40 per cent in 1937-38 to 80 per cent in 1949-50 on an estate valued at £1.25 million.⁴ What is also important to note is the pace of rise in these rates. Between 1919 and 1938, the highest effective rate rose from 40 per cent to 50 per cent on estates more than £2 million in value, whereas in the next eleven years it rose from 50 per cent to 80 per cent; a generation has grown up

¹ For, after all, holding the estate until one's death involves a certain cost because of the existence of death duties. Estate duty is the cost for holding the estate for the two years before death. Hence, the equilibrium point for the intersection of the cost and utility curves of holding property during this period would recede and the property so held be smaller than if there were no such tax.

² 'When taxation is imposed at a progressive rate on property passing at death only, the larger property owners are likely to give during life a larger proportion of their estates than smaller property owners.' J. Wedgewood, *The Economics of Inheritance* (1929), p. 211.

³ W. Taussig, *Principles*, Vol. II, p. 508.

⁴ The highest effective rate in 1937-38 was 50 per cent on estates valued above £2 million. In addition, in 1937-38 legacy or succession duties, as the case may be, were also payable. But the rate for direct descendants was only 1 per cent. These additional duties were altogether abolished as from 31 July 1949.

in the midst of such a drastic rise in the rates of death taxation. One should not be surprised therefore, if for this very reason the awareness of the burden may be far greater than if the process had more evenly been spread over time. If one goes by Josiah Wedgewood's guess made in the late 'twenties, that 'on the average, persons with large estates of say over £50,000 give away to heirs and others during their lifetime not less than a quarter of their property,'¹ there is every reason to believe that the proportion would be much higher today.²

Whatever be the proportion of private property gifted away before death, one thing is certain and that is the arbitrariness of the spread of tax avoidance (or tax incidence) as between taxpayers. There may be some who manage to dispose of their entire estate in time to secure total exemption from duty and there must be others who are unable, for any one reason, to gift away any part of their estate and on whom the hammer falls with full force. And all this disparity in tax treatment arises not because the death-tax legislation stipulates it that way but because there are differences among the taxpayers in their ability to circumvent the law.

Strangely enough, this defect in the British death taxation has not received the notice it deserves, not even in quarters most keen on employing death taxation as an instrument for rectifying economic inequalities. Dalton, for instance, refers to the possibility of evasion by transfers in gifts and concedes that, in principle, these transfers should be treated on the same footing as inheritances. But in the same breath he says that 'in practice it seems hardly possible either to tax all such gifts as inheritances or effectively to prohibit them altogether.'³ Besides, he seems to believe that the existing British practice of subjecting gifts made within five years of death adequately meets the situation.⁴

¹ Op. cit. p.236. According to Wedgewood, it is a mistake to imagine that gifts *inter vivos* were of little importance before the rise in the rates of death duties, for he found them 'frequently referred to in the wills of a generation ago.'

² According to Professor James Meade, 'death duties at their present extremely high rates on large properties are likely to become progressively less effective in diminishing the inequalities of the ownership of property, since more and more property will be passed from father to son before the death of the father.' *Planning and Price Mechanism* (1948), p.36.

³ *The Inequality of Incomes* (1929), p.325.

⁴ In 1929, when gifts made within 3 years were liable to death duties, Dalton appeared content with the results. And although he himself was the author

In a number of other countries however, where death taxation has been in force for some time, governments have taken some positive measures to counteract the increasing tendency on the part of the people to gift away their estates before death. Within the British Commonwealth, a separate tax is levied on gifts *inter vivos* in Australia, Canada and New Zealand. While a separate gift tax does possibly net in most of the gifts *inter vivos* which would otherwise have escaped any duty, opportunities might still remain for tax avoidance unless a gift tax is properly integrated with death duties. It would be correct to say that the scope for tax avoidance is an inverse function of the degree of integration secured between a gift tax and death duties.

Integration is most essential in two respects: (i) rate structure, and (ii) aggregation. Gifts should be liable to a rate of duty which does not give them an advantage over bequests. Any differentiation in favour of gifts is likely to put a premium on gifts as a means of property disposition. If the purpose is, as it should be, to make the gift tax and death duties neutral as between different channels of property disposition, the taxes should be made to apply at the same rate whether it be a gift or a bequest. But it is not enough to equate the rate of these duties. It is also essential that the tax base is homogeneous and indivisible for both the gift tax and death duties. Otherwise, under a progressive rate structure there is advantage to be gained in splitting up one's estate between gifts and bequests even when the rates are the same for either form of disposition.

In the U.S.A., gifts, other than those made in contemplation of death,¹ are liable to a gift tax levied at three-quarters of the rates prescribed for the federal estate duty. In addition, gifts are treated separately for purposes of rate determination. They constitute an independent tax base, enjoying a separate exemption limit. Thus, there is advantage to be gained not only in giving away property in the form of gifts because the rate at which the tax is payable is lower than if charged to the estate duty, but in

of the proposal to extend the statutory period from 3 to 5 years, made in 1946 as the Chancellor of the Exchequer, he did not show in his budget speech or in later discussion any particular fervour for it.

¹ There exists in the U.S. law a rebuttable presumption that a transfer within 3 years of death is in contemplation of death. It has, in practice, been found not possible to press this clause. In other countries, however, the law is more specific in that it makes gifts liable to duty if they are made within a certain period irrespective of whether or not the donation was in contemplation of death.

splitting it up between gifts and bequests in such a way that the estate as a whole bears the minimum tax burden. Also in Canada and New Zealand, the rates of the gift tax are lower than the rates of their respective death duties, and gifts are not aggregable with bequests to form one homogeneous tax base. In the U.S.A., gifts made by a donor during his lifetime are aggregable over time (except for very small gifts which are neither dutiable nor aggregable). The purpose seems to be to discourage the splitting up of gifts with a view to avoid (or to reduce liability in respect of) even the gift tax. In Canada and New Zealand also, gifts are aggregable in this limited sense but only over a specified period.¹ Thus in both these countries it is possible to reduce tax liability by splitting up gifts over time. In Australia, although the rates are the same for gifts as for bequests they are aggregable separately and that too over a specified period,² as in Canada and New Zealand.

Vickery has pointed out a 'less frequently recognized'³ form of tax avoidance. This is made possible by the provision in the tax legislation of most countries having a gift tax that the liability for the gift tax constitutes a debt payable by the donor. As is laid down in New Zealand's Death Duties Act, the gift tax is a charge which 'a beneficiary is, unless otherwise provided by the terms of the gift, entitled to be indemnified by the donor.' Similar provision exists in Australia, Canada and the U.S.A. The effect of this provision is that while death duties are payable out of the tax base, the gift tax is paid out of funds separate from the tax base. This reduces the tax liability in two ways. Firstly it reduces the tax base chargeable to duty⁴, and secondly it reduces

¹ In Canada, there is an annual tax imposed on gifts in any one year, and in New Zealand, a gift is aggregable for purposes of assessment with all other gifts, not exempt from duty by virtue of their nature, made within 12 months previously or subsequently by the same donor.

² Gift tax is payable in Australia 'on the sum of the value of a gift and all other gifts made whether at the same time or within 18 months previously or 18 months subsequently by the same donor to the same or any other donee.'

³ Op. cit. p. 204.

⁴ To quote Vickery's example, 'if gifts are subject to a 50 per cent rate, a man with \$150,000, could give \$100,000 and pay the 50 per cent tax with the remaining \$50,000, whereas if the \$150,000 were left in the estate and subject to a 50 per cent tax rate the tax would be \$75,000.' (Op. cit. p. 204). In terms of symbols, we may say that, if 't' represents the rate of tax (assuming the rates being the same for gifts as well as bequests), 'T1' the tax yield under estate duty, 'T2' the tax yield from gift duty, and 'A' the total value of the estate, then:

the rate at which it is chargeable under a progressive rate structure. In India, to rectify this position, it will be necessary to assess the liability on a gift gross of tax, on the assumption that the charge is on the gift and not on the estate which remains after making the gift.

It is clear from what has been said so far in regard to gifts that (i) a tax on gifts is an essential complement to any scheme of death duties; (ii) such a tax should be levied at the same rates as death duties; (iii) gifts should be aggregable with the property passing on death for the purpose of rate determination; and (iv) a tax on gifts should be assessed like death duties on the gross amount of the tax base (i.e. on a gift gross of tax.). In order to fulfil the third requirement which, in a way, is the corner-stone of an integrated system of death and gift taxation, it will be essential to follow the cumulative method of tax assessment. If a gift tax is combined with an estate duty, the current gifts given by a donor will be added to the total of all other gifts given away by him so far, culminating with the bequest at his death. The tax currently due on a gift will be the difference between the tax calculated on the new total and the tax computed on the previous total.¹ If a gift tax is combined with a succession duty, the gifts and legacies received by a person will be taxed currently according to the cumulative tax base formed of gifts and legacies received so far.

Considerations based on equity and justice suggest that the combination of gifts with succession for the purposes of taxation has more to be said in its favour. Under this combination, the tax liability is related to the accretion of economic power. Not only that, the adoption of this combination will pave the way for relating tax liability on gifts and bequests received with the donee's own capital holding. For a person receiving a certain amount in gift (or bequest) has a higher taxable capacity if he already owns some property than if he does not own any.

In not providing for the taxation of gifts *inter vivos* as a part of

$$\begin{aligned}
 & T_1 = t(A) \\
 \text{and} \quad & T_2 = t(A - T_2) \\
 \therefore & T_1 = T_2(1 + t) \\
 \text{and since 't' is positive i.e. } t > 0 & \\
 \therefore & T_2 < T_1
 \end{aligned}$$

¹ This procedure is already being followed in the U.S.A. for the taxation of gifts *inter vivos*, but it does not culminate with the aggregation on death of gifts made during one's life with the bequest.

or as a complement to the estate duty, the law in India has failed to profit by the experience of other countries in this respect. Although the rates of the Indian estate duty are at the moment not high compared to those obtaining in some other countries, they are high enough to set the potential taxpayers thinking in terms of tax avoidance. For, after all, until recently the Indian taxpayer did not expect to pay any tax on death and now he is faced with the prospect of having as much as 40 per cent of his estate sliced off after his death. Before long, India will have to introduce a tax on gifts. When she does so, it would be advisable to integrate the gift tax with a succession duty (in place of the recently introduced estate duty) on the lines indicated above.

CHAPTER 12

PROGRESSION IN RATES OF DUTY

ESTATE duty under the Indian law is levied on the principal value of the estate passing on death. In order to arrive at the principal value, the first step is to aggregate the various constituents. The principles governing aggregation have already been dealt with in Chapter 9. It has been observed that some of the exempted estate is and some is not aggregable. The next step after aggregation is to deduct from the sum thus obtained those liabilities which are recognized as validly owed by the deceased or which constitute a genuine charge on his estate.

DEDUCTIONS FROM CHARGEABLE ESTATE

The Indian estate duty allows deductions in respect of bona-fide debts incurred by or incumbrances of the deceased, including dower debts, up to a maximum of Rs. 5,000 and reasonable funeral expenses up to Rs. 1,000. At the Select Committee stage of the Indian law, it was suggested that a specific provision might be made for the deduction of tax arrears outstanding against the deceased. Although this suggestion has not been incorporated in the law itself, the Central Board of Revenue has indicated that it would treat 'taxes of whatever nature which have become due up to or on the date of the death'¹ as debts which would be appropriately deductible. In the case of debts owed to persons residing outside India, however, deduction is not to be allowed in the first instance except from the dutiable property of the deceased situated abroad. Further deduction on account of such debts might be allowed to the extent to which it is shown to the satisfaction of tax authority that the property abroad is insufficient to meet those debts. Other minor deductions which may be allowed are in respect of the cost of realizing or administering foreign property to the extent of 5 per cent of the value of such property, and death duties paid in a non-reciprocating country² in respect of the foreign property which is also dutiable in India. In Australia,

¹ *Hints on Estate Duty*, Government of India, New Delhi, 1953, p. 11.

² i. e. a country with which no arrangement has been made for avoidance or relief of double taxation with respect to estate duty.

the estate duty law permits deduction from the total duty of (a) the amount of duty paid abroad on estate situated outside Australia, or (b) the amount payable in respect of that estate in Australia, whichever is less. In India, and also other countries of the Commonwealth, relief of the type given unilaterally by Australia is permissible only where the government has entered into an agreement with a foreign government for the avoidance or relief of double taxation with respect to the estate duty. India has not so far entered into any such agreement.

DIFFERENT SYSTEMS OF PROGRESSION

After the permissible deductions have been made from the principal value of an estate passing at death, the question arises as to the rate at which the estate duty is to be charged. In India, as elsewhere in the world, the estate duty is a progressive tax. A tax is progressive if the rate at which it is charged increases with the increase in the value of the tax base. This element of progression in a tax scale may apply in either of the two ways. Under one system known as 'totality progression', successively increasing rates are applied to the entire tax base and not to any part of it only. Under the other system known as 'bracket progression', the successively increasing rates apply to succeeding increments of the tax base.¹ In choosing between the two systems, the Indian estate duty breaks away from the British precedent. In the U.K., and also other countries of the British Commonwealth, successive rates apply to the entire estate (or share of the estate where there exists a succession duty as well).

As is pointed out by Shultz, the virtue in progression by totality is that the tax produces greater revenue than a similar tax with parallel bracket rates, because the high rates in a rate schedule following the former progression apply to the entire mass of an estate instead of to certain fractions of it only. This he regards as very significant from the point of view of popular opinion. 'The mass of voters and taxpayers looks only at the rate-per-cents as they appear on paper without consideration whether they apply to entire estates or only to fractional parts, and simply

¹ What are referred to as 'totality progression' and 'bracket progression', are also known as 'step progression' and 'slab progression', because under the former system the rate fixed for a step in the tax scale applies to the entire value of the estate, whereas under the latter system, the entire estate is split into slabs according to the respective rates provided for them.

does not realize that one form of tax is heavier than the other."¹ But Shultz is not unaware of the drawbacks of this system of progression. The acceleration of rates by totality progression, he concedes, is very uneven. In amplification, he refers to the case 'when the taxable value exceeds the lower limit of a schedule division very slightly, since the entire value is taxed at the higher rate of the new division, the increase of the tax will exceed the increased amount of the bequest, and the beneficiary will actually receive less from the larger bequest.'² What Shultz is, in effect, saying is that under progression by totality, at every step when the rate rises the marginal rate of tax³ for estates of the lowest value in a schedule division or step may be higher than 100 per cent.

It is unfortunate that Shultz does not press his point further. He seems content with the 'margin relief' provision which is usually made by countries adopting this system of progression. In the U.K., for instance, provision was made in the Finance Act of 1914 to the effect that the amount of the estate duty chargeable on an estate was to be the highest amount of duty payable at the next lower rate plus the amount which brought the estate over the next step in the scale. In other words, the additional duty cannot exceed the additional value which has attracted the higher rate of duty, i.e. the marginal rate of tax is not allowed, by virtue of this provision, to exceed 100 per cent. Although, by making such a provision, a manifest cause of injustice is removed, the fact remains that even then the marginal rate of tax would be as high as 100 per cent for estates of the lowest value within a schedule division compared to the lower marginal rates applying to estates of higher values. More than that, the marginal rate within a schedule division varies regressively with the rise in the value of the estate. This is true of every step in the rate structure which follows totality progression. If death duties do affect certain useful incentives adversely one could not, perhaps, look for a worse system of tax levy than totality progression, for under such a system, not only does the highest rate affecting the margin go as far as to expropriate 100 per cent but it also begins applying from the very first step in a rate schedule.

¹ Op. cit. p. 291.

² Ibid. p. 292.

³ i.e. dT/dY when 'T' stands for tax liability and 'Y' stands for the tax base.

In Australia, New Zealand, and South Africa, an attempt has been made to overcome the above defect in totality progression by making the steps in their respective rate schedules extremely small, so that the rate of increase for each succeeding bracket is very minute. In Australia, the rate of tax increases by $\frac{3}{100}$ per cent for every additional £100 for estates valued up to £20,000, by $\frac{2}{100}$ per cent for every additional £100 for estates valued at between £20,000 and £120,000, and by $\frac{1}{200}$ per cent for estates valued at between £120,000 to £500,000. For estates of £500,000 and above there is to be applied a flat rate of 27.9 per cent.¹ In New Zealand, the rate increases much more rapidly, and except the estates valued up to £5000, in which case the rate rises for every £500, the increase in rate is related to a step of £1,000 in the value of estate, until the rate reaches 40 per cent for estates valued at over £100,000.² In South Africa, the rate is made to increase consistently at the rate of $\frac{3}{100}$ per cent for every £100 subject to a maximum rate of 20 per cent.³ The objection raised regarding the uneven and regressive spread of the marginal incidence of tax would still apply to the system of progression in the above three countries, for within a schedule division, however small it may be, the marginal rate does vary regressively with the rise in estate value. But it could be argued, and perhaps with a good deal of force, that in terms of incentives the term 'margin' is not necessarily co-extensive with the unit of money and that for some property groups, the margin may be as high as even £1,000. The objection raised may, no doubt, still hold in terms of money units but the adverse effect on incentive may be negligible.

The technique of progression developed in the afore-mentioned three countries of the Commonwealth may be described as a compromise between totality progression and bracket progression. The former gives rise to uneven and regressive incidence and the latter perhaps highlights the marginal rates so much that its adverse incentive effects might happen to be out of proportion to the rise in the effective rate applying to an estate as a whole.

¹ These rates have been in force in Australia since 1941.

² Refers only to the estate-duty rates which were in vogue before being cut down by 20 per cent under the Death Duties Amendment Act of 1952.

³ Refers to the estate-duty rates only. Under the Amendment Act of 1954, the duty calculated at these rates is first to be reduced by £676 (this implies a general exemption from estate duty of estates valued at £15,000 and below) and then a rebate of 20 per cent is given over the remaining amount.

In India, the rate structure for the estate duty has, to begin with, been based on bracket progression. Later on, however, considerations of redistributive finance and also, perhaps, of revenue (though receipts from death duties are far from being an ideal form of finance for public outlays¹) may force the government to raise the present rates. In that case, it is quite likely that the 'tax illusion', which the totality progression is said to create among the taxpayers,² might weigh the scales against the present system of progression. But, if the worse pitfalls of totality progression are to be avoided, it is essential that, when it is adopted, the steps in its rate scale should be as small as possible.

EXTENT OF PROGRESSION

The estate duty is known to be a progressive tax all over the world. But the extent of progression differs from country to country. Differences in the extent of progression arise because of two factors. Firstly, the general exemption limit varies from country to country, and secondly the rate of progression over the range covered by the progressive scale is not the same for all the countries.

EXEMPTION LIMIT

In perhaps every country levying an estate duty, there is a provision exempting estates of certain specified value and below entirely from its payment. The considerations prompting the fixation of such a limit are those of redistributive finance and of administrative efficiency and financial economy. Without going into the how and why of the considerations of redistributive finance, it may be said that they would apply with much less force to taxes on capital than to taxes on income. For the basic premise of a minimum subsistence level determining the floor of taxable capacity would be open to question if it is related to the holding of property.³ The really important consideration which argues in favour of the exemption of small estates is that of avoiding

¹ The question of usefulness of death duties as a source of government finance has already been dealt with at length.

² Shultz has given considerable importance to this aspect of totality progression, *op. cit.* p. 291.

³ We may hasten to add that the concept of 'minimum subsistence level' is still a definitional conundrum and anyone talking in terms of 'a property-owning democracy' may set down a minimum property limit as part of the subsistence level.

the unproductive effort involved in collecting small amounts of tax from a multitude of taxpayers. Dalton placed considerable emphasis on this aspect of his proposal to raise the exemption limit in the U.K. from £100 to £2,000. In effecting this proposal, he expected to relieve about 75 per cent of the erstwhile taxpayers entirely from the payment of the estate duty at the cost only of less than 2 per cent of the revenue from this source.¹ It was again as a result of his initiative that the Chancellor agreed to exempt, as from 31 July 1954 estates not exceeding £3,000 in value.² The administrative expense involved in the assessment of small estates is usually much out of proportion to the revenue yield not only because of the existence of fixed costs of assessment but also because a larger proportion of the estates held at the lower rungs of the property ladder is represented by such types of property as present the most difficult problems of valuation.³

The Indian estate duty exempts all estates of Rs. 100,000 and below. Compared to the exemption limit in the U.K. of £3,000 (Rs. 40,000) the limit in India is undoubtedly high. It would not need statistical evidence to establish that the average per capita property-holding is much lower in India than in the U.K. or that the minimum essential property-holding (if one were to concede the legitimacy of this sort of argument) could on no account be regarded as higher in India than in the U.K. It is therefore correct to say that the primary consideration which did, probably, prevail with the Indian government in fixing such a high exemption limit was that of administrative expense. It was perhaps regarded as advisable to start with a small tax-paying clientele. Whether or not it will be possible to bring down the exemption limit, will depend on the results of the experience gained in the administration of the existing duty. But in an economy where greater reliance is placed on capital taxes as a means of government finance and which has

¹ *Parliamentary Debates (Commons)*, 1945-46, Vol. 421, p. 1836.

² *Ibid.* 1953-54, Vol. 529, pp. 2234-46.

³ Information regarding the property-composition of estates at the time when Dalton raised the exemption limit from £100 to £2,000 is not available. Figures for 1937-38 (the last year before World War II for which information was published) show that for estates of £100—£1,000 group, items like house property and business premises, trade assets, household goods, and unclassified property comprising mainly of personalty, together accounted for nearly 40 per cent of the value of estates as compared to the overall proportion of 20 per cent for these items for the estates as a whole. (Source: 81st Report of the Commissions of H.M.'s Inland Revenue for the year ending 31 March 1938).

in existence a recurrent annual tax on capital and an adequate tax machinery with a well equipped and properly staffed valuation office, the fixed costs of assessment per estate would be far lower than where assessment of estates has to be undertaken only for the purposes of taxation at death.¹

Now, the existence of an exemption limit affects the extent of tax progression in two ways. In the same community, a high exemption limit makes it essential for the rate scale to be high enough to make up for the loss of revenue² from those estates which might have been charged in the case of a lower exemption limit. Perhaps, this would not materially affect the revenue field, and, therefore, the rate scale. The experience in the U.K., shows that the revenue-yield from small estates has all along been very insignificant indeed. In another sense, however, it does affect tax progression. A tax may be highly progressive as between the different sections of the taxpayers liable to duty but it is, of course, not progressive as between those who are entirely exempted. This is a fact which cannot be overlooked in a country like India, where persons with estates of over Rs. 100,000 in value constitute a far smaller proportion of the working population than they do in the U.K.³ And, among the vast majority of the people who are totally exempted, there will continue to be great disparities in property-holdings remaining untouched by the estate duty. Surely the government in India, which introduced the estate duty with an explicit intention of reducing the inequalities of wealth, cannot overlook this fact.⁴ It is

¹ The marginal expense of covering an additional property bracket under estate duty will be much lower if it is already within the review of, say, an annual tax on capital.

² In so far as it is a consideration that weighs with the government.

³ According to a study by the author (results not yet published) it is estimated that only about 5 out of every 20,000 'self-supporting persons' may be owning property over Rs. 100,000 in value in India. This compares with the corresponding figure for the U.K., of nearly 240 out of every 20,000 persons aged 25 or above. The denominators used for the two countries are not strictly comparable because the 'self-supporting persons' in India include some below 25 and exclude all above 25 who are not earning an income which is sufficient for their own maintenance, whereas in the U.K. all persons of 25 and above are included. The figure for the U.K. is based on Kathleen Langley's estimates of the distribution of capital for the year 1946-47. *Bulletin of the Oxford University Institute of Statistics*, December 1950.

⁴ The Statement of Objects and Reasons accompanying the Estate Duty Bill expressed the hope that 'by the imposition of an estate duty . . . unequal distribution may be rectified to a large extent.'

therefore likely that after some time as the government gains in experience of the administration of the estate duty, the exemption limit will be lowered to a value more consistent with the disparities in property-ownership in India.

RATE OF PROGRESSION

It is common ground to say that a rate-scale is progressive where the marginal rate of tax exceeds the average rate when moving up the scale. Any number of rate-scales may be proclaimed as progressive if they satisfy this primary condition. But it is difficult to say which one is more progressive than the other. The difficulty arises partly because the marginal rate curve or the average rate curve representing a scale seldom has the same slope over the entire range, and curves for different scales may steepen or flatten at different points, and it is, therefore, not possible to say whether one curve is on the whole more progressive than the other. The rate of progression may be different for the different zones in a range, and comparison between any two curves can profitably be made in terms of comparable zones instead of for an entire range. The other part of the difficulty arises from the ambiguity in our definition of the term 'progression'. As it is, this definition is compatible with a number of alternative measures of rate graduation which may not produce identical results. Pigou refers in this connexion to average rate progression and marginal rate progression.¹ Musgrave and Tun Thin add to this list three others: liability progression, residual income progression, and effective progression.² These various measures of progression, 'if applied to any one rate structure will show different degrees of change in progression.'³ In certain cases, the movements may even appear to be in the opposite directions, that is, while according to one measure of progression, the tax-scale may look like becoming more progressive, the other type may show progression on the decline for the same rate structure over the same zone.

A brief description of the five measures of progression referred to above would perhaps be useful. The average rate progression measures the rate of change in the average rate of tax and the marginal rate progression measures the rate of change in the

¹ *A Study in Public Finance* (1947), p. 50.

² 'Income Tax Progression, 1929-48', *The Journal of Political Economy*, December 1948.

³ Musgrave and Tun Thin, *op. cit.* p. 498.

marginal rate of tax.¹ Both these measures assess changes in rates only from one point to the other without relating them to the corresponding magnitude of the tax base at the two points. The distinction between these two measures and the liability progression is a particular case of that between a weighted and an unweighted index number because the liability progression measures the rate of change in the effective rate of tax as related to the relative change in the tax base.² Actually, the choice between these three measures should be so obvious. The results obtained from the first two measures could be misleading for the simple reason that they do not take into account changes in the tax base.

As regards the other two measures: residual estate progression (corresponding to residual income progression) and effective progression, the redistributive aspect of progression is highlighted by relating, in the first case, changes in estate values net of tax to changes in estate values gross of tax,³ and in the second case, the coefficient of equality of distribution of estates net of tax to the coefficient of equality of distribution gross of tax.⁴ No doubt, a progressive tax whatever its rate of progression, exercises some redistributive effect. But the calculation of coefficients of distribution before and after taxation presumes

¹ In terms of algebraic symbols, the measures may, following Musgrave and Tun Thin, be put as under:—

(i) *Average Rate Progression*

$$\frac{T_1}{Y_1} - \frac{T_0}{Y_0} \quad / \quad Y_1 - Y_0$$

(ii) *Marginal Rate Progression*

$$\frac{T_2 - T_1}{Y_2 - Y_1} - \frac{T_1 - T_0}{Y_1 - Y_0} \quad / \quad Y_2 - Y_1$$

where 'Y' stands for income and 'T' for tax yield and subscripts 0, 1 and 2 indicate the time periods. For our purposes, 'Y' could be taken to stand for the value of estate chargeable to duty.

² In algebraic terms, liability progression can be written as (notations being the same as for note 1 above):

$$\frac{T_1 - T_0}{T_0} \cdot \frac{Y_0}{Y_1 - Y_0}$$

³ The formula for residual income (or estate) progression is:

$$\frac{(Y_1 - T_1) - (Y_0 - T_0)}{Y_0 - T_0} \cdot \frac{Y_0}{Y_1 - Y_0}$$

⁴ Dalton was presumably the first to suggest this type of measure as an alternative to his variant of average rate progression which is an unweighted measure of progression between two points on a tax scale.

TABLE 1
**RATES OF ESTATE DUTY PROGRESSION IN RESPECT OF TAX-
 RATES APPLICABLE IN INDIA, CEYLON, PAKISTAN AND
 THE UNITED KINGDOM**

<i>Value of Estate (Rs)</i>	<i>India</i>	<i>Ceylon</i>	<i>Pakistan</i>	<i>U.K.</i>
200,000	4.00	2.50		4.00
300,000	2.86	1.43	2.00	4.00
500,000	2.12	1.63	2.25	2.50
1,000,000	1.95	1.40	3.17	2.34
2,000,000	1.65	1.67	1.40	1.50
3,000,000	1.49	1.38	1.50	1.60
5,000,000	1.49	1.28	1.00	1.21
10,000,000	1.43	2.00	1.00	1.15
20,000,000	1.11	1.67	1.00	1.29

NOTES:—

(i) It will be observed that progression rates have been calculated in terms of estate values at specified points and not for different brackets.

The following formula has been used in calculating the rates of progression:—

$$P = \frac{To - To-1}{To-1} \cdot \frac{Yo-1}{Yo - Yo-1}$$

where 'P' stands for the rate of progression at a given point, 'To' for the tax payable in respect of estate valued at 'Yo', and 'To—1' for the tax payable in respect of the estate valued at 'Yo—1', i.e., at the point preceding the one under consideration.

(ii) The distance between the points follows the Indian rate-scale; for other countries, the rate of progression has been calculated on the assumption of the same distance as for India although in actual fact, the distance differs for each country's rate-schedule.

(iii) Since the progression in the Indian rate-schedule follows the slab system unlike in the rate-schedules of Ceylon, Pakistan and the U.K., where estate duty progression is based on the step system, the comparisons in this table need to be interpreted with caution. Under the slab system, the rate of progression within a bracket, i.e. from one point to the other, varies in a descending order because with the marginal rate of tax remaining constant, the average rate of tax, and therefore the liability, rises at a declining rate. On the other hand, under the step system, there is no progression at all within a bracket (i.e. the rate of progression within a bracket equals unity which indicates proportionality), although as stated in the text the marginal rate is as high as 100 per cent to start with and declines gradually as one approaches the highest limit in the bracket.

(iv) The conversion rate used for different currencies is as follows:—

Rs. (India) 100 = Rs. (Ceylon) 100 = Rs. (Pakistan) 100 = £(U.K.) 7.5

(v) In the case of Pakistan, the rate is infinity for an estate valued at Rs. 200,000 because no duty is leviable on an estate of Rs. 100,000 and below and for estates up to Rs. 200,000 the effective rate of duty is 6 per cent.

knowledge of the distribution pattern. It is an assumption too bold to make in the case of India at this stage of statistical availability.

In Table 1, we compare the rate of liability progression in the Indian estate duty under the present law with the rates it would have if it were to adopt the tax-rates applicable in Ceylon, Pakistan, and the United Kingdom. Comparison has not been extended to the other four countries of the Commonwealth because in all of them the estate duty is supplemented by a succession duty (in Australia, this is imposed by the State governments) and their estate duty rates are not by themselves comparable therefore with those in countries where the estate duty is the sole representative of death duties.

It will be observed that for the Ceylonese, Pakistani and British rates, the rate of progression shows a tendency to decline with the rise in estate value. This tendency for the rate of progression to decline reflects hesitation on the part of authorities to raise the rate of duty beyond a certain point. There is, however, a certain amount of irregularity in this decline in the rates of progression. For Pakistani tax rates, the rate of progression rises from 2·0 to 2·25 in moving from an estate valued at Rs 300,000 to that valued at Rs. 500,000. It rises further to 3·17 at Rs. 1,000,000 and then falls to 1·40 at Rs. 2,000,000 but rises to 1·50 at Rs. 3,000,000. The peak tax rate having been reached, the tax becomes proportional thereafter and the rate of progression is equal to unity. For the British rates, the rate of progression falls from 4·0 at Rs. 200,000 to 1·5 at Rs. 2,000,000 but it rises to 1·60 for Rs. 3,000,000 and falls again to 1·15 at Rs. 10,000,000, going up thereafter to 1·29 at Rs. 20,000,000. For Ceylon, the rate of progression declines from 2·50 at Rs. 200,000 to 1·67 at Rs. 20,000,000. But the decline takes place in a markedly uneven and vacillating fashion. It falls sharply to 1·43 at Rs. 300,000, rises to 1·63 at Rs. 500,000, falls again to 1·40 at Rs. 1,000,000 followed by a rise to 1·67 at Rs. 2,000,000, reaches the lowest point of 1·28 at Rs. 5,000,000, and then rises to 2·00 at Rs 10,000,000 before reverting to 1·67 at Rs. 20,000,000. In the case of the Indian estate duty also the rate of progression registers a decline with the increase in the value of estate and of the rate of duty. It falls from 4·00 at Rs. 200,000 to 1·11 at Rs. 20,000,000 but the decline takes place smoothly and without any kink.

While there is a certain amount of justification for the rate of progression to decline gradually as the peak tax rate is approached, there does not appear to be any ground for the rate of progression

to rise for some points, to fall for some others and then again to rise for some subsequent points in the tax-scale. This seems to involve some sort of rough justice which says that progression should rise at a high rate for the lowest values, at a lower rate for some intermediate values and at a higher rate for the next higher values. In fact, if the argument developed earlier in this study that death duties do not constitute a particularly suitable source of public revenue is accepted, there would be no justification even for a declining rate of progression. This need not be taken to suggest the rejection of the plea for a maximum feasible rate at any time.¹ On the contrary, we suggest a gradually falling rate of progression as from the highest value to the lowest value after the fixation of the maximum feasible rate. The rate of decline in progression downwards may be the same throughout the line or it may gradually rise. But it should not be allowed to fall because that would be inconsistent with the purposes of progression as such.

COMPARISON OF TAX RATES

Whatever the differences in the objectives underlying the imposition of death duties, and in the progression in tax-rates, the consideration which weighs with any taxpayer is that of the relative incidence of different rate-scales at given points. The comparison he would usually make would be of the type: 'Do I have to pay more or less on my estate under the British rates than under the Indian rates?' In Table 2 overleaf, we have attempted to compare the death duties payable under the rates now applicable in India and in other countries of the Commonwealth. Since, the purpose is to compare the direct money incidence of death duties according to the rates applicable in all these countries, it has been considered advisable to include the succession duty levied in Canada, New Zealand and South Africa in our calculations for these countries. Both in Australia and Canada, death duties are also being levied at the State levels but their rates vary from State to State and it has not been found possible to take them into account for purposes of national comparisons. Other limitations of the table are indicated in the accompanying notes.

The table, as it is, makes some interesting disclosures. Although the British rates are far and away, the highest for higher values of estate, the New Zealand rates are higher than the British rates

¹ Economic considerations alone are never the sole arbiter in the fixation of such a limit. But even they would not suggest any hard and fast line which might be said to be universally applicable.

TABLE 2
LIABILITY TO DEATH DUTIES AT RATES APPLICABLE IN INDIA
AND OTHER COUNTRIES OF THE BRITISH COMMONWEALTH

<i>Value of Estate (Rs.)</i>	<i>India</i>	<i>Austra- lia</i>	<i>Canada</i>	<i>Ceylon</i>	<i>New Zealand</i>	<i>Pakistan</i>	<i>South Africa</i>	<i>U.K.</i>
In Percentages								
100,000	Nil	1·86	Nil	4·0	14·32	Nil	3·00	3·0
150,000	2·50	3·60	Nil	5·0	16·56	6·0	4·00	6·0
200,000	4·38	4·61	Nil	7·0	18·24	6·0	4·00	8·0
300,000	7·08	7·62	11·0	8·0	22·72	8·0	7·00	15·0
500,000	10·25	10·96	17·0	10·0	28·22	12·0	11·56	24·0
750,000	13·50	16·20	23·0	11·0	38·26	15·0	16·55	35·0
1,000,000	15·13	20·74	26·0	12·0	42·80	25·0	21·28	40·0
1,500,000	18·42	26·10	29·0	14·0	44·80	30·0	23·50	50·0
2,000,000	20·06	26·34	32·0	16·0	44·80	30·0	23·64	50·0
3,000,000	23·38	26·81	35·0	18·0	44·80	35·0	23·76	60·0
4,000,000	26·28	27·27	38·0	20·0	44·80	35·0	23·82	60·0
5,000,000	28·03	27·64	41·0	25·0	44·80	35·0	23·99	65·0
7,500,000	32·02	27·90	44·0	30·0	44·80	35·0	24·00	70·0
10,000,000	34·01	27·90	48·0	30·0	44·80	35·0	24·00	70·0
15,000,000	36·01	27·90	52·0	35·0	44·80	35·0	24·00	80·0
20,000,000	37·00	27·90	52·0	40·0	44·80	35·0	24·00	80·0
30,000,000	38·00	27·90	54·0	40·0	44·80	35·0	24·00	80·0

NOTES:—

GENERAL:

(i) The duties included are the estate and succession duties wherever levied by the Central government; for Australia where the succession duty is charged at the State levels and at varying rates only the estate duty has been taken into account.

(ii) The rates shown are applicable to the value of estate, at specific points indicated in the table.

(iii) The conversion rate used for different currencies is as follows:—

Rs. (India) 100=£ (Australia) 9·6875=\$ (Canada) 21*=Rs. (Ceylon and Pakistan) 100=£ (U.K., New Zealand, and South Africa) 7·5.

*Since 30 September 1950, the Canadian dollar does not have a fixed rate of exchange. We have, for our purposes, taken it as on par with the U.S. dollar although it is at present being quoted at some premium.

INDIA

(iv) Rates shown apply to an estate other than that belonging to the legally recognized joint family; also the rebate admissible for agricultural land has not been taken into account.

AUSTRALIA

(v) The provision regarding statutory exemption as amended in 1953 has been applied as if the estate were to pass to a direct descendant.

CANADA

(vi) Since it is assumed that the whole estate passes in succession to one adult

child, no allowance has been made for individual exemption admissible in case of succession to a widow or a child below 18.

CEYLON

(vii) Rebate allowed through a scaling down of non-urban land value by 10 per cent has not been taken into consideration.

NEW ZEALAND

(viii) The general rebate in duty authorized under the Death Duties Amendment Act of 1952 has been allowed for. But allowances admissible in respect of devolution to the widow or children below 21 have not been taken into account because it is assumed that the whole estate passes on to one child.

SOUTH AFRICA

(ix) The rebate admissible under the Amendment of 1954 has been allowed for and the succession duty element is calculated on the assumption that the estate passes to a direct descendant.

UNITED KINGDOM

(x) Rate reduction authorized in respect of agricultural property and certain business assets has not been taken into consideration.

for estates ranging in value from Rs. 100,000 to Rs. 1,000,000. For an estate of Rs. 100,000, the New Zealand rate is nearly five times the British and South African rate, over three and a half times the Ceylonese rate, and nearly eight times the Australian rate. Under the Indian and Pakistani rates, no duty is payable on estates valued at Rs. 100,000 or below. Nor is any duty payable in Canada on estates of similar size. Higher up in the scale, however, for an estate of Rs. 1,500,000, the New Zealand rate is 44·8 per cent compared to 50 per cent of the U.K., 30 per cent of Pakistan, 29 per cent of Canada, 26·1 per cent of Australia, 23·5 per cent of South Africa, 18·4 per cent of India, and 14 per cent of Ceylon. Under the New Zealand rates, the general exemption limit is extremely low, and the rate of progression is very high for the lower range of estate values. These two factors combined account for the fact that in New Zealand, an estate valued at Rs. 100,000 is expected to pay nearly 14·3 per cent in death duties as compared to 3 per cent in the United Kingdom. The general exemption limit under the New Zealand rates is Rs. 6,666 (£500) compared to Rs. 20,000 in Ceylon, Rs. 40,000 (£3,000) in the U.K., Rs. 66,666 (£5,000) in Australia¹, Rs. 100,000 in India and Pakistan and Rs. 238,095 (\$50,000) in Canada. In South Africa, no estate duty is leviable until after the estate value reaches Rs. 200,000 (£15,000), but the succession duty is payable on a legacy of over Rs. 1,333 (£100). As to the

¹ The exemption limit for legatees other than direct descendants is Rs. 33,333 (£2,500).

rate of progression, the New Zealand rates register a rise of 11·0¹ in the range of Rs. 6,666 (£500) to Rs. 66,666 (£5,000) and of 3·8 in the range of Rs. 66,666 (£5,000) to Rs. 933,333 (£70,000), whereas in the U.K. the rate of progression is nearly 4 in the range up to Rs. 66,666 (£5,000) and over 21 in the subsequent range (of course, broken in a number of zones in the tax-scale) up to Rs. 1,000,000 (£75,000). In India, no duty is, as already observed, payable on an estate of Rs. 100,000 and the rate of progression up to the value of Rs. 1,000,000 comes to nearly 7·0.

It is also worth noticing that the rates of duty in India are among the lowest over a wide range of estate values. For estates valued up to Rs. 3,000,000 Ceylon alone of the Commonwealth countries levies rates lower than in India. Compared to India's rate of 23·38 per cent for an estate of Rs. 3,000,000, the rate in other countries is as high as 60 per cent in the U.K., 44·8 per cent in New Zealand, 35 per cent in Canada and Pakistan, 26·8 per cent in Australia, and 23·76 per cent in South Africa. In Ceylon, the corresponding rate is 18·0 per cent. In Australia and South Africa, the rates at this level are very near their respective peak rates of 27·9 per cent and 24 per cent. For Pakistan and New Zealand, the rates at this level are the respective peak rates. But in India and the other three countries, the peak rates are reached much later. In the U.K., the peak rate of 80 per cent is charged on estates valued at over Rs. 13,333,333 (£1,000,000). In Canada, the peak rate is 54 per cent levied on estates of over Rs. 23,809,500 (\$5,000,000). In Ceylon and India, the peak rate is 40 per cent, but in Ceylon it is charged on an estate of over Rs. 15,000,000 whereas in India even for an estate of Rs. 100,000,000 the rate applicable is 39·4 per cent.²

¹ Refers to liability progression over the range described.

² In fact as the marginal rate for estates valued at over Rs. 5,000,000 is not to exceed 40 per cent, the peak rate can at the most approach 40 per cent but never be equal to it.

CHAPTER 13

DIFFERENTIATION UNDER ESTATE DUTY

WHEN any part of an estate passing at death is treated differently as compared to the rest of the estate, differentiation may be said to exist. Reference has already been made in Chapter 9 to exemptions granted to particular forms of property such as household goods up to a certain value, books and objects of art and insurance policies up to certain values and of certain types. In all these cases, it is obvious that differential treatment is being accorded to certain categories of property in respect of estate-duty liability.

DIFFERENTIATION IN FAVOUR OF LAND

Differentiation may be either complete or partial. The cases referred to above belong to the first category because differentiation operates for those types of property through complete exemption from liability to the estate duty. In the second category, comes the treatment accorded to agricultural land. The estate-duty law in India treats land differentially in two ways: (i) it has scaled down the rates of duty applicable to an estate, or any part of an estate, consisting of agricultural land; and (ii) it has set down a ceiling for the value of agricultural land for purposes of its assessment to duty. Where an estate consists wholly or partially of agricultural land and the principal value of the estate (i.e. the entire estate including agricultural land) does not exceed Rs. 200,000, a rebate of 25 per cent is allowed in respect of the duty payable, under the normal rates, on the part of the estate which consists of agricultural land.¹ As regards the valuation of agricultural land, it has been decreed by the Central Board of Revenue that it cannot be assessed for a value in excess of twenty times the 'annual value' as assessed for purposes of land revenue.²

Treatment of agricultural land for purposes of death taxation has been a subject of considerable argument in the U.K. A

¹ Section 35 (3) (a) and (b) of Estate Duty Act of 1953.

² Rule 14 (6) of Estate Duty Rules, 1953 reads thus: 'In the case of any agricultural land the principal value shall not ordinarily exceed twenty times of the annual value as assessed for the purpose of land revenue.'

century or so of death taxation in the U.K., has witnessed a number of changes for and against agricultural land. Death duties did not apply at all to landed property when they were first imposed and even when it was brought within the orbit of death taxation, it was to be evaluated much more liberally than the rest of the property. Under the Succession Duty Act of 1853, landed property was to be valued not on the market value basis but as a life estate according to the age of the inheritor. The Finance Act of 1894 retained the discrimination in favour of landed interests by limiting the value of agricultural land, for purposes of death taxation, to twenty-five times the gross property tax assessment. In 1910, this differentiation in favour of agricultural land was abolished and, for a time, it could be said that landed property was being accorded no differential treatment in respect of death taxation. But this did not last long, and in 1925, Mr (now Sir) Winston Churchill agreed to the application of lower than normal rates of the estate duty to agricultural land. It was decided that any increase over the estate-duty rates fixed in 1919 would not apply to the agricultural value¹ of agricultural land. Since then, the general rates of the estate duty in the U.K. have increased considerably but agricultural land has remained untouched. In 1949, when all the death duties extant so far were combined into a single estate duty, agricultural land was enjoying a rebate of nearly 45 per cent on the normal rates and this was formalized by providing for a general abatement of 45 per cent of the estate duty chargeable under the new rates on the agricultural value of land.² It is worth noticing however, that in the U.K., the earlier practice of specifying a ceiling on land value for purposes of tax assessment was not revived when the concession to agricultural land was re-introduced in 1925.

As regards other countries of the Commonwealth, no differentiation is known to exist in favour of agricultural land whether in the matter of rates or in the matter of valuation in Australia, Canada, New Zealand, Pakistan and South Africa. In Ceylon, the basis of valuation is the same for all types of property but the value so determined has to be reduced in respect of land outside

¹ Agricultural value is defined under the British law as 'the value the property would bear if it were subject to a perpetual covenant prohibiting its use otherwise than as agricultural property, less the value of any timber, trees, wood or underwood.' R. Dymond, *The Death Duties* (1946), p. 131.

² Ironically enough, this measure was introduced by the Labour Party, who in 1925 were vehemently opposed to this type of differentiation.

the limits of an urban local authority by 10 per cent. This abatement in value is not admissible in respect of land used for building or mining.

The main support for this privileged treatment of agricultural land comes from the argument that a high estate duty forces disintegration of large landed estates with, perhaps, detrimental effects on agricultural output. People with predominantly agricultural interests are known to be generally not so liquid as those with investments in commerce and industry. Agricultural landowners, it is sometimes explained, 'have had singularly few opportunities as compared with other members of the community with equal wealth, of saving out of income for the purpose of meeting death duties.'¹ This is so, firstly, because the market value of land very often contains elements other than just its income-producing value² (and, therefore, the income-capital-value coefficient for land is usually lower than for other types of property), and secondly, because the level of private expenditures of big landlords is much higher than of the parallel commercial and industrial sections of the community. Now, it is true that agricultural land does usually sell for a value higher than would be justified by its income-yield, but those other elements, which fetch a price in the market, yield to the landowner certain satisfactions which he would have gone without but for his ownership of land. What he does not secure from land in the form of 'income', he obtains in the shape of direct satisfactions.³

The British Committee on National Debt and Taxation emphatically rejected the above plea for treating landed estates partially. It regarded it as a root principle of the estate duty that it was levied on the value of the capital assets irrespective of whether they yielded money income or not. It was, therefore, considered undesirable that an exception should be made in the case of agricultural assets.⁴ As to the other reason based on a differential level of private expenditures, it should suffice to say that there is as little justification for taking cognisance of this

¹ Shultz, *op. cit.* p. 223.

² Shultz refers to three elements apart from the income element in the land values: (i) 'potential value' based on resources which, though unworked, could yet be converted into cash on sale: (ii) 'alternative value' for building or resort purposes; and (iii) psychic value in possessing the land. *Op. cit.* p. 223.

³ The term 'income' is being used here in the sense of tangible return from land.

⁴ *Report* (1927), Cmd. 2800, p. 187.

consideration in respect of the estate duty as there may be for granting higher exemptions from income tax to sections of the community with higher standards of personal expenditures. If the British estate-duty law retains differentiation in favour of agricultural land it is in spite of the firm verdict of the above Committee against its continuation, and it appears to be, by now, firmly entrenched.¹

If the British experience is any guide in this matter of differentiation, it is not expert opinion but political clamour which was responsible for the revival and retention of the concession in favour of agricultural land. Expert opinion has, in fact, been averse to this differentiation. India has seemingly chosen to follow the British precedent, but the rebate allowed by the Indian duty is lower than that in the U.K. The most important consideration, as has been observed above, which weighed with the British government was (and, perhaps, is) the adverse effect of the estate duty on large landed estates. In India, however, the government is, publicly at least, wedded to a policy of breaking up large landed estates.² It is, therefore, somewhat difficult to explain this concession to landowners.

If one goes by the ceilings set on land ownership in different States in India, where legislative measures have already been adopted for the abolition of feudal interests in land, one can foresee that, after land reform has made sufficient headway in India, very few landed estates will come within the orbit of the present estate duty.³ Landed estates in that foreseeable

¹ At least there does not appear to be any near prospect of even a modification. Both the parties in the British Parliament avowed their support to the existing rate-concession to agricultural property. Dalton, on behalf of the Labour Party, gave it as his considered opinion that 'the balance was in favour of maintaining it.' *Parliamentary Debates (Commons)*, 1953-54, Vol. 529, p. 688.

² The Agrarian Reforms Committee (1949) of the Indian National Congress declared itself unequivocally for the fixation of a ceiling on land holding 'which should not be more than three times the size of the economic holding.' (See p. 24 of the *Report*). This was accepted by the Planning Commission, which refers approvingly to the limits set by the States on holdings which can be retained by landowners affected by the abolition of feudal interests. The Commission has gone further and recommended that in other areas as well there should be set 'an absolute limit to the amount of land which any individual can hold.' *The First Five Year Plan*, pp. 186 to 190.

³ Assuming that no holding would be allowed to exceed 100 acres of unirrigated land (the maximum laid down for individual holdings varies from State to State ; it is 30 acres in Uttar Pradesh, 50 acres in Madhya Bharat, and five

future will come in for liability to the estate duty if the deceased held, in addition, some non-agricultural property ; and the higher the value of these non-agricultural assets the greater the incidence of the estate duty on the agricultural part of the estate as well, because of the progressive character of the rate-scale. Viewed in this light, relief under the Indian duty will operate regressively in favour of persons less and less connected with agriculture. This might, to a certain extent, encourage people to secure interest in land up to the maximum admissible under the law without being really interested in agriculture as a means of livelihood. How far it would really bolster up absentee landlordism—a feature which has for so long a time been the very bane of Indian agriculture—it is difficult to say, but the fact that relief of the above nature could reinforce incentives of a harmful type should not be overlooked.

DIFFERENTIATION IN FAVOUR OF BUSINESS ASSETS

So far, we have concentrated on differentiation in favour of agricultural land. Recently in the U.K., the concession operating in favour of agricultural property has been extended to certain business assets as well. As from 30 July 1954, a reduction of 45 per cent in the normal estate-duty rates is to be allowed in respect of industrial premises and plant and machinery owned by a private business concern.¹ It is interesting to note that the treatment of business assets of private concerns for the purposes of death taxation has for long been the subject of public discussion in Britain. The British Committee on National Debt and Taxation (1927) went into this question but its conclusion was that while cases of hardship might undoubtedly occur, the estate duty did not appear to be a major factor tending towards the disintegration of private businesses, whether carried on by sole or partnership traders, or through the medium of a private joint-stock company.

The British Committee had based its conclusions on the results of the statistical enquiry conducted on its behalf by the

times the family-holding in Hyderabad). The market value (in the sense of agricultural value) of 100 acres of land varies, according to current estimates, from Rs. 10,000 to Rs. 80,000 depending on the various factors entering into land valuation.

¹ It includes a business or an interest in a business whose shares and debentures are, for the purpose of the estate duty, valued by reference to the value of the total assets of the business.

Board of Inland Revenue. Since the clamour for concession in favour of private business revived with the recent increase in the estate-duty rates, the Board of Inland Revenue thought it proper to undertake a fresh enquiry so as to find out how severe the impact of death duties was on private business estates. The enquiry was conducted on more or less the same lines in 1951 as in 1927 and the verdict was again unfavourable. The Board did not come across any case 'in which a business has in fact been broken up by the operation of death duties.'¹ Still the claimants have won. As already stated, they have now secured a rebate of 45 per cent on the estate duty in so far as it applies to industrial premises, and plant and machinery owned by private business.

The question that now arises is : Would it be justifiable on the part of the government in India as well to grant some concession in the estate duty to private businesses? Family businesses and private companies do still play an important role in the Indian economy.² It is also likely that they might, given adequate facilities, be able to contribute considerably in the development of the economy in so far as the task of development is left to the private sector. Also, the Five Year Plans assign a definite place to small-scale industries and regard their proper development as a task of equal importance with the planning of agriculture, or transport or industry.³ True, that many small industrial units may not come within the orbit of the present estate duty either because they are run on co-operative lines (a form of business organization which receives the widest measure of support from the Indian Planning Commission), or because they are individually so small as to fall below the exemption limit. But there will still be quite a number of medium-sized units under private control which are large enough to attract duty. In such cases real hardship may be caused by liability to the estate duty,

¹ 'Estate Duty and Family Businesses', *Report on Statistical Investigation by the Board of Inland Revenue* (1951), Cmd. 8295.

² There is hardly any statistical evidence available to support this statement. Only a rough idea could be had from the data published in the *All-India Income Tax Report and Returns*. For the year 1951-52, the total number of supertax assesses (that is the class likely to be covered by the estate duty) was 49,079. Of this number, 10,644 were companies and 9,302 were salaried people. Assuming that the rest were engaged in some sort of business, their total net earnings as assessed to tax accounted for nearly 40 per cent of the total income (non-agricultural, of course) assessed to income or supertax in the country.

³ The First Five Year Plan, p. 326, The Second Five Year Plan, p. 429.

especially if it arises at an inconvenient time when sufficient liquid or easily realizable resources are not readily available.

The data published by the British Board of Inland Revenue as part of the reports on the enquiries of 1927 and 1951 show that (a) the incidence of the estate duty on private businesses is not particularly severe on business interests forming part of relatively small estates; (b) the incidence of the estate duty is likely to impinge on private businesses in cases where private business assets comprise a large proportion of the capital-value of the estates; and (c) since the rates under a progressive duty rise with the increase in the capital value of estates, the proportion of estates experiencing difficulty on the above account will increase for every successive range provided, of course, that the relationship between the total capital-value and the part represented by private business interests remains the same.¹

Any measure intended to alleviate hardship should apply to estates most likely to face difficulties. The rate of concession given in the U.K., however, applies to all estates having an interest in private business to the extent to which the business is comprised of industrial premises,² and plant and machinery. Relief is thus admissible not only to estates most prone to difficulties, but to all estates many of whom may possess assets other than interests in private business in sufficient proportion so as to meet the estate duty without any special hardship. A general relief of this type has something to be said against it because, instead of merely giving protection to cases which are likely to be hit particularly hard by the estate duty because of their large interests in private business, it provides an avenue of tax-avoidance for all and sundry. It would not surprise us if this type of general relief may initiate a movement away from public companies to private companies (other forms of private business organization being too small to be taken to compete with public companies), this being a means by which liability to the estate duty can be reduced. If it is decided to protect interests in private business without setting afoot other trends in the economy, it is essential that this relief should be administered selectively, that is, it should be given

¹ These points have not been clearly stated in the official reports; a critique of the enquiries has, therefore, been prepared and included as an appendix to this chapter.

² Stands for land or premises used in business, but 'excludes dwelling houses, retail shops, distributive premises, stores and premises generally which are used for purposes which are not those of a factory or workshop.'

only to estates which are otherwise likely to suffer differentially. It may, for instance, be prescribed that relief will be admissible only to those estates whose interests in private business comprise more than a certain percentage of the capital-value of their estates; for estates with a small proportion of interests in private business could be expected to meet their estate duty from their other assets. The minimum percentage may be fixed on a sliding scale so as to vary inversely with the increase in capital value of the estate and related to the rate structure of the estate duty. A restriction of this type will reduce the number of cases in which relief will have to be given and will confine it to cases of genuine hardship.

TREATMENT OF JOINT FAMILY ESTATES

Closely related to the general question of differentiation is the one relating to the treatment of joint estates. Any deviation from general rules in regard to the treatment of shares held in joint property will obviously lead to differentiation. Joint estates should not ordinarily present any special problem of differentiation because in the eyes of law the interests of the co-sharers are usually separable and identifiable as such. For purposes of death duties, therefore, the practice generally adopted is to regard the share of a deceased man in joint property as falling within the category of property of which he was at the time of his death competent to dispose.¹ Complications arise in India not because estates are so often held jointly but because the right to joint ownership is regulated variously for different sections of the Indian people, and differentiation results if the same rate of duty is charged on estates passing on death under different systems governing the devolution of property.

Broadly speaking, there are now in vogue in India two systems of inheritance to property: (a) where property devolves by virtue of survivorship in a joint family; and (b) where property passes by succession.² The difference will be made clearer by an illustration. Under the first system, a male child becomes a member of

¹ In the U.K., if the joint tenant of a property dies without having severed his share, his share is chargeable with the estate duty 'either as property of which he was competent to dispose (F.A. 1894, S.2 (1) (a), or as property in which he had an interest ceasing on his death (S.2 (1) (b)).' R. Dymond, *op. cit.* p. 68.

² There do exist a variety of practices within this system but the common feature among them all is that of devolution of property rights by succession.

the joint family, and therefore a co-sharer of the family property, from its very birth.¹ Under the latter system, the child acquires a right to a part or the whole of the property only on the death of the testator, who until his demise holds it entirely to himself and the child cannot claim any part of it during the testator's lifetime. Under the system where property devolves by virtue of survivorship, the interest of a coparcener changes both with the birth and the death of other coparceners, whereas under the system where property devolves by succession, the interest of a co-sharer in the joint property undergoes a change only on the death of other coparceners.

The application of the same rate of the estate duty to two estates of equal value but governed by separate systems of inheritance gives rise to tax-differentiation in three ways:—

(i) Since under the system of inheritance by survivorship, the estate is at any given time held jointly by more than one person with usually varying ages, the probability of its becoming liable to the estate duty is higher than would be the case with an estate governed by the system of inheritance by succession. Let us by way of illustration take the case of an estate held jointly by male members consisting of the head of the family 'A', his only son 'B', and his only grandson 'C'. The death of any one of these three would subject the estate to death tax, though in part. But if the same estate were held exclusively in the name of A, as will be the case under the system of inheritance by succession, with B and C living as his dependants, the estate would become liable to estate duty only on A's death and if B and/or C dies while A is alive, the estate will not become liable to duty.

(ii) The fact that in India the infant mortality rate continues to be much higher than the mortality rates for other age groups weighs the scales still further against the joint family estate because of the virtual omnipresence of child coparceners.

(iii) In one respect, however, the joint family estate has an advantage over other estates and this advantage arises because at any time when the estate duty becomes payable, only a part and never perhaps the whole of the estate becomes dutiable. Continuing with our earlier illustration of a joint family comprising three males, father, son and grandson, we assume further

¹ Strictly speaking, the child acquires this right from the day it is conceived in the mother's womb. See R. N. Bhargava, *Principles and Problems of Inheritance Taxation* (1952), p. 140.

that deaths take place in 'natural order'¹ and are reasonably spaced in time. Then, if the joint family estate is represented by the symbol 'X', the sum assessed to tax by the time C dies will be $\frac{1}{2}X + \frac{1}{2}X + X$ (i.e. $2X$). This would be so if no further births took place in this family and when C died, he was the sole member of his family. A more realistic assumption will be of a male birth replacing every male death in such a way that the original order of relationship is maintained. In that case, the total sum assessed to duty between A's and C's deaths will be equal to $\frac{1}{2}X + \frac{1}{2}X + \frac{1}{2}X$ (i.e. $1\frac{1}{2}X$). Whereas, if the estate were held in the exclusive ownership first of A, then of B, and thereafter of C, during the same stretch of time (i.e. between A's and C's deaths) the sum assessed to duty would be $3X$ which is twice as much as that for the joint family estate.² Thus the same estate would be liable to pay twice as much in estate duty if it did not belong to the joint family and if the duty were levied on a proportional basis. It can be shown that for a larger family, the disparity in the incidence of estate duty would be still greater.³

The estate duty law in India attempts to rectify the differentiation referred to in the preceding paragraph. It lays down, for instance, that in the case of a joint family estate the duty will become payable only if the deceased coparcener had completed his eighteenth year at the time of his death. Of course, the duty will be payable on the share of the deceased coparcener even if he had not completed his eighteenth year at the time of his death, if his father or other male ascendant in the male line having joint interest with him is not alive.⁴ This provision regarding the exemption of minor coparceners does, no doubt, meet very largely the objection raised above regarding the differential incidence on a joint family estate because of the high infant mortality rates but it will still not rectify the differential arising because of the deaths occurring in a family in other than the 'natural order'. If the deaths occur in the natural order, a joint family estate stands

¹ i.e. the grandson to follow the son and the son to follow the father.

² Our illustration derives from the note of the Legal Adviser to the Indian Taxation Enquiry Committee. He, however, calculated the disparity on the basis of the discounted value of the estate after every death assuming that the deaths took place after every 30 years. But, as the same discount applies to both the types of estates, the rate of disparity remains the same as for our calculations. *Report* (1928), Vol. II, Appendix XII.

³ It is all along assumed in these computations that the estate remains intact in spite of its having to pay estate duty at the turn of each of the three generations.

⁴ The Estate Duty Act, 1953, Section 7(2) (a) and (b).

to gain because a part of the estate would escape taxation during each generation. It is perhaps with a view to rectifying this differential in favour of a joint family estate that the general exemption limit has been fixed at a lower level for a joint family estate than for other estates. And, since the progression of rates of duty follows the slab system, there is throughout the scale a certain proportion of surcharge payable in respect of a joint family estate. The effective rate of surcharge is about 1·7 per cent on the deceased coparcener's share valued at Rs. 150,000 and it declines to 0·04 per cent on the share valued at Rs. 7,000,000. The surcharge applicable on the intervening capital-values is indicated in Table 3 below.

TABLE 3
EFFECTIVE RATES OF ESTATE DUTY CHARGEABLE IN INDIA ON
JOINT FAMILY AND OTHER ESTATES

<i>Capital-value of Estate</i> (Rs.)	<i>Rate applicable to Joint Family Estate</i> (per cent)	<i>Rate applicable to other Estates</i> (per cent)	<i>Surcharge on Joint Family Estates</i> (per cent)
100,000	2·5	Nil	2·5
150,000	4·167	2·5	1·667
200,000	4·625	4·375	1·25
300,000	7·917	7·083	0·834
500,000	10·75	10·25	0·5
1,000,000	15·375	15·125	0·25
2,000,000	20·188	20·063	0·125
3,000,000	23·458	23·375	0·083
5,000,000	28·075	28·025	0·05
7,000,000	31·482	31·446	0·036

NOTES:

- (i) In the case of a joint family, the term 'estate' refers to the share of the deceased coparcener and not to the entire property held jointly in the family.
- (ii) The term 'joint family' is used only for those families in India which are governed by the system of inheritance by survivorship.
- (iii) The exemption limit for joint family estates is Rs. 50,000 and for other estates it is Rs. 100,000.

Does this surcharge effectively counteract the differential it seeks to rectify? If for our illustration of the family of three male members jointly owning an estate valued at Rs. 200,000, it is assumed that the rates of duty would remain the same over the three generations, the undiscounted sum of the estate duty payable between A's and C's deaths will be Rs. 7,500, whereas if the same estate were held exclusively in the name of A and then of

B and thereafter of C, the estate duty payable over the three generations will amount to Rs. 33,750.¹ The only case where it would be profitable to break up the joint family estate is when as a result of partition the estate of each of the erstwhile coparceners falls below the higher exemption limit applying to other than joint family estates, for in that case no duty would be payable. In any other case, it would be profitable to keep the estate as in the name of the joint family rather than in any one coparcener's name to the exclusion of others. But, what if the order in which deaths take place is not the natural one? Perhaps A outlives both B and C. Let us assume that during A's lifetime, death takes place first of B and then of C (C, the grandson being over 18 years in age at the time of his death). In undiscounted values, the total duty payable by a joint family estate after A's death would amount to Rs. 7,500. Still, the amount payable if the estate were dutiable only on A's death, he being the exclusive holder, shall be Rs. 11,250, that is higher by Rs. 3,750. The relative gap, is, however, smaller in terms of discounted values. Assuming that deaths take place at the interval of five years, the sum of the estate duty discounted at the rate of 6 per cent is Rs. 5,764 for the joint family estate and Rs. 6,282 otherwise.² This shows that even in cases where deaths do not occur in natural order, the existing rate of surcharge is not enough to rectify the differential which operates in favour of the joint family estates.

On the basis of what has been said above, it has to be conceded that the estate duty in India inclines heavily in favour of a joint

¹ The discounting of these sums for the period elapsing between the generations would not affect the relative differential in the incidence of estate duty.

² The figures have been worked out as under:—

	JOINT FAMILY ESTATES		OTHER ESTATES	
	<i>Undiscounted value of estate duty</i> (Rs.)	<i>Discounted value of estate duty</i> (Rs.)	<i>Undiscounted value of estate duty</i> (Rs.)	<i>Discounted value of estate duty</i> (Rs.)
On B's death	2,500	2,500	nil	nil
On C's death after 5 years.	2,500	1,868	nil	nil
On A's death after another 5 years.	2,500	1,396	11,250	6,282
Total:—	7,500	5,764	11,250	6,282

family estate. And, as only a particular section of the community is almost eternally endowed with this benefit by virtue of having been born in a joint family, no person from the other sections of the community can avail himself of this benefit by a transfer to the joint family in the legally recognized sense. This discrimination in favour of the legally recognized joint family operates in two ways. It is in a sense double-edged. On the one hand, the persons governed by the three inheritance laws, known as the MITAKSHARA, MARUMAKHATTAYAM, and ALIYASANTANA laws, have the exclusive benefit of the differential arising because of the division of the estate at birth, to which anyone not born in a joint family can never become entitled. On the other hand, there is freedom for the coparceners in a joint family of exit and re-entry. A coparcener may ask for partition and separate from the joint family. Once separated, he may rejoin the family he left, or set up a distinct joint family. One could conceive of cases of partition in a joint family at one stage and its reformation into one or more joint families at a later stage according as the coparceners see their advantage in terms of the estate duty.

The Indian Taxation Enquiry Committee (1926) had recommended the introduction of an estate duty in the country primarily with the purpose of correcting the inequitable way in which the then existing probate duties fell on different sections of the population. The inequity of the probate duties should have increased with the enhancement of rates since the publication of the Report. But it never became a real public issue because the securing of a probate or succession certificate was obligatory on an exceedingly small fraction of the country's population. But with the introduction of a universally applicable estate duty, the distinctions drawn between joint family estates and other estates leading to considerable tax discrimination in favour of the former type of estates cannot escape public attention because nearly one-third of the population is not covered by the joint family system.¹ It is likely that this tax discrimination may,

¹ Estimates of the distribution as between the systems of property devolution are not available, but a rough guess taking into consideration the facts that (a) Hindus in Bengal, Assam, and the major part of Bihar are governed by the Dayabhaga system, and (b) Muslims and other sections not covered by the Hindu Law are governed by systems where inheritance derives from succession, will place the people not following the legally recognized joint family system at no less than 30 per cent of the total Indian population.

if referred to the courts, be found to be repugnant to the fundamental right to equality of treatment in law as enshrined in the Constitution.

That being the order of inequity caused by the differentiation inherent in the present estate duty, one can visualize attempts at its reform in the not very distant future. One approach that immediately suggests itself is that of increasing the surcharge on normal rates for application to joint family estates. But this approach cannot eliminate differentiation; it may reduce it. The difficulty is that even with a set of higher rates for joint family estates different estates will feel the incidence differently according to the strength and composition of the joint families. The incidence of the estate duty will fall capriciously in varying proportions on different estates. Another approach would be to treat all devolutions on birth as chargeable to the estate duty in the same way as devolutions on death. But in view of the high incidence of mortality in India in early years, it may be regarded as unduly harsh to treat devolutions on birth and their subsequent reversion on death as transfers liable to duty. The present complaint regarding high incidence of child mortality may soon be a thing of the past. Considerable advance is afoot in the sphere of preventive and curative measures for rectifying the present situation and, as in other countries, the impact of these measures should soon be noticeable. But even during the intervening period when child mortality continues at a high level the combination of the birth and death duties with the estate-age relief recommended in Chapter 10 should, it is felt, adequately meet the objective, provided they are complemented with a properly integrated gift tax. Unfortunately, there does not appear to be any short-cut solution to this issue. So long as property devolution is governed by separate systems for different sections of the community, the incidence of a uniform impost related to devolution will continue to give cause for complaint on the score of differentiation.

APPENDIX TO CHAPTER 13

A CRITIQUE OF THE OFFICIAL ENQUIRIES¹ ON 'ESTATE DUTY AND FAMILY BUSINESS' IN THE UNITED KINGDOM

THE first enquiry was undertaken by the Board of Inland Revenue at the instance of the Committee on National Debt and Taxation (1927). It had been represented to the Committee that death duties fell with particular severity upon estates of persons who were engaged in private business. In a sense, enforcement of any tax measure of general applicability will be found to cause some extraordinary hardship in certain individual cases. The question to be examined, therefore, was the frequency of this hardship and this depended upon the extent to which persons with private business interests tended in general 'to invest in them the whole or by far the greater part of their fortunes,'² so that recourse had to be had to the sale of business assets with a view to meet death duties. The second enquiry whose results were published in 1951 was undertaken by the Inland Revenue on its own initiative in order to investigate the impact of the post-war high rates of the estate duty on private businesses.

COMMENTS ON THE METHODS OF ENQUIRY

For the first enquiry, estates of over £10,000 net capital value which were charged to estate duty in the first three months of the year 1922 comprised the primary data. Of 1342 such estates, 373 (i.e. merely 28 per cent.) were found to include 'trade assets' exceeding £1,000 in value. Trade assets were defined to include shares in private companies, the net value of any interest in a partnership and the gross value of trading assets held by individual traders. Gross value had to be used for this last item because of the difficulties involved in tracing debts

¹ The report of the first enquiry was published as Appendix XX to the Report of the Committee on National Debt and Taxation (1927), Cmd. 2800; the report of the second enquiry was published in July 1951 as a separate Command Paper, Cmd. 8295.

² Cmd. 2800 (1927), Appendices, p. 147.

specifically outstanding against it for any one estate. This might have resulted in a certain amount of overstatement of the position of trade assets relative to estate values. On the other hand, the exclusion of the business bank and cash balances from trade assets might have led to their understatement. To some extent, therefore, the one should have offset the other. In any case, it is gratifying to note that it was possible to work out for the second enquiry the trading assets of the individual traders on a net basis.

Estates below £10,000 were excluded from the purview of the enquiries presumably 'because the duty in such cases would obviously have been too small to exercise any adverse effect on the business.'¹ It is true that for a vast majority of estates below £10,000, hardly any difficulty is likely to be experienced on account of liability to the estate duty because of the very smallness of the charge. But it is not the vast majority that concerns an enquiry of this nature. It is that section of the tax-paying estates which is likely to experience particular hardship because of a preponderant interest in private business that should be our chief concern. And, this difficulty or hardship may as well arise in the case of some estates of less than £10,000. According to the 1927 enquiry, of the 10 estates in 373 which had trade assets exceeding even their net capital value, 7 belonged to the range of £10,000—£25,000. Of the 25 estates whose trade assets comprised over 80 per cent of their net capital value, 23 were also in the range of £10,000—£25,000. Although, according to the 1951 enquiry, of the 18 cases in which trade assets constituted over 100 per cent of their net capital value, none were in the ranges of £10,000—£20,000 and £20,000—£50,000 and 15 belonged to the range of £50,000—£100,000, there were in the lower range no less than 50 estates out of a total of 111 in whose case the net value of the trade assets comprised between 90 to 100 per cent of their capital value. If one goes by the above figures, it seems to us quite conceivable that cases might exist even among estates of less than £10,000 where estate-duty payment might be the cause of extraordinary hardship of the type under investigation.

In both the enquiries, cases where trade assets were below £1,000 were excluded from the purview of detailed investigation on the assumption that non-trade assets in any such case would generally be sufficient to pay the duty. One may be in accord with the general assumption that where trade assets are relatively

¹ Cmd. 8295 (1951), p. 3.

very small, the estate duty will be met without difficulty, but the way it has been applied is certainly open to objection. What has actually happened is that while for smaller estates of a little over £10,000, the limit of £1,000 is tantamount to the elimination of cases where trade assets comprise about 10 per cent of net capital-value, for bigger estates in the sample¹ the minimum percentage which trade assets might bear to the net capital-value might be far smaller than 10 per cent. It could perhaps be claimed with justification that even in the latter case (i.e. of bigger estates) where non-trade assets constitute as high a proportion as 90 per cent of the net capital-value they would always be adequate to pay the duty. Of the 373 estates in the sample for the 1927 enquiry, 113 estates were such as included trade assets amounting to less than 10 per cent of their net capital-value, and of the 3,290 estates in the sample for the 1951 enquiry, 597 estates were of similar type. The inclusion of such estates in the sample of an enquiry of this nature creates, in our view, a bias against private business. It inflates the 'population' in the sample of estates not likely to be adversely affected and therefore leads to the understatement of the relative importance of the estates prone to the adverse impact of the estate duty. For instance, if these estates were excluded from the sample, the cases in which non-trade assets were insufficient to cover the duty would constitute 4·6 per cent and 7·6 per cent for the 1927 and 1951 enquiries respectively as against 3·2 per cent and 6·2 per cent with the sample remaining unmodified.

COMMENTS ON THE OFFICIAL CONCLUSIONS

The Board's conclusion after the first enquiry was that 'viewed broadly, the burden of the Estate Duty does not appear to be a major factor tending towards the disintegration of private businesses.'² For after all, only '3·2 per cent of the 373 estates including trade assets, or 0·89 per cent out of the total number of 1,342 estates examined, were cases in which the burden of the Estate Duty may have been a cause of serious difficulty when viewed from the special standpoint of preserving intact the whole of the gross trade assets, any trade debts being regarded as a charge on the private assets.'³ The second enquiry is stated to

¹ The term 'sample' is being used in this Appendix to stand for the estates of over £10,000 in whose case the trade assets exceed £1,000 in value.

² Cmd. 2800 (1927), Appendices, p. 151.

³ Ibid. p. 151.

confirm, more or less, the verdict given in 1927. For only 6·2 per cent of the 3,290 estates including trade assets or 1·6 per cent out of the total number of 12,986 estates examined, were cases in which the non-trade assets were insufficient to cover the estate duty.¹ Even these figures are alleged to overstate the position of cases which are likely to experience particular hardship in meeting the estate duty, because the 'trade assets' as defined in the earlier enquiry and used for the above comparisons included 'shares in non-trading companies such as private estate and investment companies, which are often a convenient way of holding private assets; minority interests where the death of the deceased cannot lead to the break-up of the company; and partnership interests where the partnership deed provides for the remaining partners to buy out the deceased's share and where therefore the incidence of the estate duty cannot affect the business as such.'² If trade assets of this type were to be excluded, and regarded as being available for the payment of the estate duty without impinging on the existence of a business as such, there will be left in the sample for the 1951 enquiry only 86 (i.e. 2·3 per cent of the 3,290) estates including trade assets in whose case private assets other than trade assets could not cover the estate duty. The Board has also pointed out that in spite of considerable public discussion on the impact of the estate duty on private business it has not so far (i.e. up to the issue of the report of the second enquiry) been confronted with a case in which a business has in fact been broken up by the operation of the death duties. In other words, even in obviously hard cases where adequate non-trade assets are not at hand, it has been possible to make some arrangement to meet the estate duty without having to dislodge the business.

As has been stated earlier, the Board's enquiries both in 1927 and in 1951 start with a bias against private business by having included in their samples of estates including trade assets, such estates as are not likely to feel the impact of the estate duty in this particular respect. A rectification of this bias should enable us to have a more accurate idea as to the relative position of such cases. We propose to exclude for this purpose those estates whose trade assets comprise less than 10 per cent of the capital-value, and then assess the relative position of hard cases within their

¹ The period covered by the second enquiry being longer than for the first enquiry, the number of estates in the sample is also larger.

² Cmd. 8295 (1951), p. 3.

respective capital-value zones. Assessment of their relative position in terms of the aggregate sample conceals the fact that the incidence of the estate duty operates with varying force as between different zones. In the two tables below, the results of the two enquiries have been reset on the above lines.

It will be observed that if the broad definition of trade assets as used in 1927 were to be retained, nearly 5 out of every 100 estates with trade assets in the first enquiry and nearly 8 out of every 100 estates with trade assets in the second enquiry could be said to face special difficulty on account of the liability to the estate duty. As for separate zones, the first enquiry showed that nearly 5 out of every 100 estates in the range of £10,000—£50,000, nearly 2 out of every 100 in the range of £50,000—£100,000 and about 6 out of every 100 in the range of £100,000—£250,000 did not possess sufficient non-trade assets to cover this liability. By the time of the second enquiry, the rates of estate duty had increased considerably for estates of higher values.¹ The impact of the

TABLE 1
RELATIVE POSITION OF ESTATES IN DIFFERENT CAPITAL-
VALUE ZONES

Range of Estate.	<i>As per 1927 Enquiry</i>		<i>As per 1951 Enquiry</i>	
	Numbers	Percentage	Numbers	Percentage
Estates of over £10,000 with trade assets comprising 10 per cent or above of the capital-value.	260 (373)	100 (100)	2,693 (3,290)	100 (100)
<i>Divided among Estates of:</i>				
(i) £10,000—£50,000	215 (298)	82·7 (79·8)	2,230 (2,580)	82·8 (81·5)
(ii) £50,000—£100,000	28 (37)	10·8 (10·0)	325 (460)	12·1 (11·0)
(iii) £100,000—£250,000	14 (25)	5·3 (6·7)	108 (180)	4·0 (5·4)
(iv) Over £250,000	3 (13)	1·2 (3·5)	30 (70)	1·1 (2·1)

¹ The percentage rise in the rates of the estate duty during the time that elapsed between the two enquiries was as under:—

<i>Estate value</i>	<i>Rise (in percentages)</i>
£10,000	Nil
£25,000	114
£50,000	210
£100,000	221
£250,000	200

TABLE 2
CASES IN WHICH NON-TRADE ASSETS WERE INSUFFICIENT
TO PAY THE WHOLE OF ESTATE DUTY

Range of Estate	<i>As per 1927 Enquiry</i>		<i>As per 1951 Enquiry</i>		<i>As per 1951 Enquiry with revised definition of 'trade assets'</i>	
	Number	Percentage.	Number	Percentage	Number	Percentage.
Cases in which non-trade assets were insufficient to cover estate duty.	12	4.6 (3.2)	204	7.6 (6.2)	86	3.2 (2.6)
<i>Divided among Estates of:</i>						
(i) £10,000—£50,000	10	4.6 (3.3)	70	3.1 (2.7)	30	1.3 (1.2)
(ii) £50,000—£100,000	1	2.2 (1.3)	90	27.7 (14.8)	40	12.3 (8.7)
(iii) £100,000—£250,000	1	5.9 (2.6)	30	27.8 (12.0)	10	9.3 (5.6)
(iv) Over £250,000	—	—	14	46.7 (20.0)	6	20.0 (8.6)

NOTES: TABLES 1 and 2

(i) The 1927 Enquiry covered estates charged to duty in England and Wales from 1 January to 31 March 1922. The 1951 Enquiry covered cases arising for the whole year of 1948. But, while in the former enquiry all cases were investigated, in the latter a stratified sample was taken, the sampling factor varying from 2 per cent for the range of £10,000—£20,000 up to 100 per cent for cases over £250,000.

(ii) For purposes of comparison, both the tables give in brackets corresponding figures based on the unmodified totals in the respective samples in the two enquiries of estates with trade assets.

TABLE 2

(iii) In the 'percentage' columns is indicated the relationship between the number of estates whose trade assets are insufficient to cover the estate duty and the corresponding number of estates in the sample in that particular zone.

(iv) The breakdown for the 1927 Enquiry has been arrived at by juxtaposing Tables 2 and 23 of Appendix XX to Cmd. 2800 (1927).

estate duty is therefore, particularly noticeable on estates of higher value during the second enquiry. While for the range of £10,000—£50,000, only 3 out of every 100 estates did not have enough non-trade assets to meet the estate duty, for the ranges of £50,000—£100,000 and £100,000—£250,000 nearly 28 per cent

of estates were in such a predicament. For estates of over £250,000 the percentage was as high as 46·7. If, however, a more restricted definition is adopted for trade assets so as to exclude interests in private investment companies, the position would appear to be less disparaging, though not so satisfactory as is made out by the Board. For estates within the range of £50,000—£100,000 the percentage of those unable to cover the estate duty from their non-trade assets is 12·3; for those in the ranges of £100,000—£250,000 and of over £250,000, the percentages are 9·3 and 20·0 respectively. In view of the above, it could not be maintained that the relative significance of estates faced with partial, if not complete, liquidation of their assets in private business is by any means negligible.

But it is worth mentioning also that of the 86 estates which were found to have insufficient non-trade assets (even when these assets were taken to include interests in investment companies etc.) to meet the estate duty, 20 per cent was accounted for by manufacturing businesses, 73 per cent by distribution businesses, and 8 per cent by other services, including hotels. It could, therefore, perhaps still be contended by those who have a soft corner only for manufacturing businesses that the effect of the estate duty in forcing private business out of manufacturing was not very significant.

As regards the point that only one case was noticed in which a business was actually broken up under the impact of the estate duty, it is true that this shows that even in many hard cases is it possible to make some arrangement without involving the break-up of the business. But, who knows if this arrangement consists of some sort of tax-avoiding action prompted by the very desire to keep the business intact in spite of the estate duty!

The conclusions which can be drawn from the enquiries of the British Board of Inland Revenue (with results presented in the modified form suggested in this Appendix) are : (a) that the estate duty is likely to impinge on private businesses in cases where private business assets comprise a large proportion of the capital-value of the estates; (b) that the impact of the estate duty on private businesses is not particularly severe if business interests form part of the relatively smaller estates; and (c) since rates under a progressive duty rise with the capital-value of estates, the proportion of the estates experiencing difficulty in the matter of payment of the estate duty will increase for every successive range, given a certain relationship between the total capital-value and the part represented by private business assets.

CHAPTER 14

VALUATION OF ESTATES

AS in other countries levying the estate duty, the law in India makes it obligatory on the part of the 'accountable persons' to submit to the tax authorities an account of all the property in respect of which the estate duty becomes payable. The persons concerned are under obligation to give details not only in respect of the property as such but have also to state the value thereof to the best of their knowledge and belief. (This is the practice we have recommended for adoption in the case of an annual capital tax and is comparable to the practice followed at present in regard to the income tax.) Of course, the values declared by the accountable persons have to be checked by the tax authorities before assessing the tax liability. The assessing officer is under no obligation to accept the values declared, and may, if necessary, make his own valuation for purposes of assessment.

Under the rules laid down by the Central Board of Revenue for the valuation of property, the value of an estate is defined as the highest price which it would fetch if sold in the open market at the time of the death of a deceased. In estimating this value no reduction is allowed on the assumption that the entire property is to be placed on the market at one and the same time. The accountable parties are expected to act as reasonably prudent persons who in such circumstances would not throw the whole of a large holding on the market at once. But consideration is allowed for any depreciation in value by reason of the very death of the deceased. Moreover, if an estate had actually been sold within a short time after the death of the deceased, the price realized is to be regarded as the value of the estate.

Although the general rule for valuation is to ascertain the value of the estate on the date of death, there may be certain items of property which do not lend themselves to such straightforward valuation. The following types of property need special mention:

(i) *Shares not quoted on the stock exchange*: Valuation of shares quoted on the stock exchange offer no difficulty. In the case of shares for which there is no stock-exchange quotation, a common method of valuation is by a comparison of the past and prospective dividends of the company concerned with the yields obtainable

from quoted shares of a similar class, after making allowance for the relative unmarketability of the unquoted shares. The Central Board of Revenue in India is prepared to accept a certificate of valuation issued by a qualified broker acquainted with the securities concerned or letters from the secretaries of the companies or corporations.¹ In the case of private companies whose articles of association contain restrictive provisions as to the alienation of shares, the value of shares, if not ascertainable with reference to the assets of the company, shall be estimated to be what they would fetch if sold in the open market on the terms of the purchaser being entitled to be registered as a holder subject to the articles of association.²

(ii) *Shares in a 'controlled company'*: Where one individual controls a company or has a preponderant interest in it, the market value of its shares may not adequately represent the real value of the predominant holding and a special method of valuation is therefore called for. The method to be adopted in such cases is to estimate the value of such shares by reference to the net value of the assets of the company.

(iii) *Agricultural land*: An important departure has been made from the principle of market valuation by the Central Board of Revenue in its decree that agricultural land shall not be valued in excess of twenty times the 'annual value' assessed for purposes of land revenue. The fixation of a ceiling on the value of agricultural land gives rise to tax-differentiation not only between land and other types of property but also between land whose market value is equal to or below twenty times the 'annual value' and land whose market value is above twenty times the 'annual value'. Also, to relate the capital value of land to 'annual value' ignores that the concept of 'annual value' used for purposes of land-revenue assessment in India has remained largely ill-defined and has therefore lent itself to diverse connotations in different parts of the country. Of immediate interest is the fact that in practically all the States where 'annual value' of land is being used for the assessment of land revenue, it was calculated a long time before World War II and bears no relation to the current level of prices in the country. To adopt it as the basis for determining the capital-value now would be, to say the least, a retrograde step.

¹ *Hints on Estate Duty* (C.B.R. 1953), p. 8.

² Estate Duty Act, 1953, Section 37.

(iv) *Joint Family Estates*: In the case of a joint family estate, the interest that ceases on the death of a coparcener will be valued as if a partition had taken place immediately before the death. 'Such a partition will be purely notional for the purpose of ascertaining the duty, and ignores the point whether the deceased had any right to claim partition.'¹ In order, however, to arrive at the value of the coparcenary share allocable to the deceased member, it will be necessary to ascertain the value of the total joint family property. In determining this value, the provisions relating to the inclusion of gifts made within the statutory period are to be applied to the entire joint family property. That is, any gift made by, say, the manager of the family within the statutory period (with reference to the death in question) may be included in the joint estate for the purpose of determining the deceased's share therein.

The Central Board of Revenue has laid down rules for the valuation of various other types of assets as well. But the initial responsibility for valuation rests with the persons accountable for the payment of the estate duty. They are supposed to submit their own estimate of value supported by such evidence as may be called for by the tax authorities. The appropriate tax authority is supposed to make sure that the valuation has been properly arrived at and, if necessary, it may seek the assistance of qualified valuers to appraise an estate. It is not yet known what procedure the Central Board of Revenue proposes for requisitioning the services of expert valuers. Whether it should rely on private valuation agencies for expert advice or it should set up a valuation agency of its own still seems to be an open question.

The Inland Revenue in Britain has got a separate valuation office which is charged with the appraisal of property for purposes of tax assessment. While the valuation office in Britain owes its origin primarily to the requirements of death duties, it has by now expanded its field of activities considerably. It makes valuations and negotiates acquisition and disposal of land for all other government departments, for local authorities and for some of the nationalized industries. Since 1948, it has also been entrusted with the maintenance of current rating valuation lists and for the preparation of new lists. It is doubtful, if the government in India can defer for very long the establishment of a suitable valuation office. The needs of the estate duty itself

¹ *Hints on Estate Duty* (C.B.R. 1953), p. 10.

would, in due course, be large enough to justify the creation of a viable valuation organization. The need will become more apparent if one were to visualize the employment of an agency like this for purposes of assessing land revenue and local property taxes and also the new annual tax on capital. Difficulties of valuation are manifold, but they cannot be got rid of by being ignored. By refusing to face the situation, the country may only be denying herself the maximum use, with minimum of unintended differentiation, of tax channels which might have a lot to be said for them on grounds of economic or social policy.

POSTSCRIPT

A CRITIQUE OF THE NEW TAXES IN THE CENTRAL BUDGET FOR 1957-58

THE budget of the Central Government in India is usually presented to Parliament on the last day of February preceding the financial year to which the budget relates. But the 1957-58 budget that was presented to Parliament at the usual time was only an interim budget. The general elections were about to conclude and the old Parliament was near the end of its days. It was, therefore, not considered appropriate to bring before the old Parliament new financial measures of any importance, even though the economic and financial circumstances called for such measures. That some drastic measures were necessary had been clear for some months. Between June 1955 and December 1956 the general price-level had registered an increase of a little over 25 per cent. Some counter-inflationary measures on the monetary front had helped to bring down the price-level but to only a very small extent.¹ The price situation at the time of presentation of the interim budget was anything but satisfactory. Still, according to the estimates of total expenditure for the year 1957-58, current receipts of the Central Government from existing taxes, borrowing and external assistance fell short by Rs. 3,650 million. This meant that if expenditure of the magnitude contemplated was to be incurred, and that too without making any effort to secure additional current receipts, the Government would have to incur a deficit to the extent of Rs. 3,650 million. The deficit in 1956-57 was of the order of Rs. 2,400 million.²

DEFICIT FINANCE

Thus the deficit of the Central Government alone in the first two years of the Second Plan would have been Rs. 6,050 million. This compares with the Plan ceiling of Rs. 12,000 million on deficit financing in the entire public sector over the five-year

¹ The index number of wholesale prices moved from 342 in June 1955 to 429 in December 1956 and was around 421 in March 1957.

² See Government of India's brochure entitled *Budget 1957-58 — Taxation Proposals Explained*, para. 8.

period.¹ But this in itself would not be an important consideration for not incurring a deficit of any order. The important consideration is the absorptive capacity of the economy, and the indications are that this absorptive capacity is already under strain and that too very largely because of the deficit financing that has gone on in the past three years. The other factor responsible for the present strain is the decline in food supply, partly because the domestic food output has not maintained² the level achieved earlier; and partly because food imports had to be restricted in order to conserve foreign exchange for the purchase of capital equipment to be installed under the Plan. In these circumstances, the Government could not with equanimity contemplate deficit financing of the order indicated in the interim budget. Since the estimates of receipts on account of borrowing and external assistance provided for the maximum that was feasible, the only way to reduce the deficit was to raise additional taxation. And remembering that (a) the *total* tax receipts of the Central Government amounted to only Rs. 4,765 million in 1956-57 and (b) the deficit confronted in 1957-58 was as large as Rs. 3,650 million, only an all-out tax effort could have any marked effect on the deficit.

KALDOR'S TAX PROPOSALS

When Mr Nicholas Kaldor put his estimate of the additional taxation required over the five-year period for the fulfilment of the Second Plan at Rs. 12,500 million instead of the Plan-estimate of Rs. 4,500 million, he remarked that 'there is nothing impossible about these targets, provided the problem is tackled on bold lines and the tax system is subjected to a thorough and comprehensive reform.'³ According to his calculations the broadening of the base of direct taxation 'through the introduction of an annual tax on wealth, the taxation of capital gains, a general gift tax, and a personal expenditure tax (the last in partial substitution of the present supertax on income)'⁴ would 'provide

¹ The Second Five Year Plan, p. 78.

² In 1953-54 domestic production of foodgrains, grams and pulses was as high as 68.8 million tons. In 1954-55 and 1955-56, the domestic production was 65.8 and 64.8 million tons respectively. The figure for 1956-57 is stated to be around 66 million tons and crop forecasts for 1957-58 lead one to believe that the current output will also be around 66 million tons.

³ *Indian Tax Reform, Report of a Survey*, issued by the Department of Economic Affairs, Ministry of Finance, Government of India, p. 1.

⁴ *Ibid.* pp. 1 and 2.

the greater part of the requirements necessary to ensure the success of the Second Five Year Plan.¹

NEW TAXES

That the Government was not prepared to incur a deficit of the order of Rs. 3,650 million was made amply clear by the Finance Minister when he presented the interim budget in February 1957. The budget presented to the new Parliament in May 1957 proposed to reduce the deficit to Rs. 2,750 million, the balance of Rs. 900 million to be met from additional taxes. Since these taxes would come into force a few months after the year had commenced, the receipts in 1957-58 would be somewhat lower than in a full fiscal year. It is estimated that in a full fiscal year these additional taxes would yield about Rs. 1,150-1,200 million. This is quite an effort, considering that it would mean securing an annual rise in the Central tax collection² to the extent of 22 per cent.

Unlike Mr Kaldor's proposals, however, the additional taxation proposed in the budget under review relies more on commodity and other indirect taxation than on direct taxation. Under the Kaldor scheme, indirect taxation excluding taxation of land would cover not more than 20 per cent of the additional tax receipts collected for the plan, whereas according to the budget indirect taxation comprises over 70 per cent of the additional revenue. This shift in accent towards indirect taxation can be regarded as a measure of the extent to which Mr Kaldor's scheme for comprehensive direct taxation has been either diluted or not implemented. Of the four new personal taxes recommended by Mr Kaldor, the capital gains tax was introduced through a mid-year Finance Act in 1956, and the wealth tax and the personal expenditure tax form part of the current year's proposals. The fourth tax, not yet introduced, is the general gift tax. In addition, the reforms suggested by Mr Kaldor in company taxation and in the reporting of income and wealth assessable to tax remain to be implemented. The low estimate of revenue from the taxes introduced reflects not a revision in calculations made originally by Mr Kaldor but rather the dilution of the taxes both in rates and in coverage.

¹ *Indian Tax Reform, Report of a Survey*, op. cit. p. 4.

² Including the amount transferred subsequently to the State Governments as their share of the Central taxes.

CAPITAL GAINS TAX¹

The capital gains tax introduced in 1956 departs from Mr Kaldor's proposal in two important respects. First, the tax exempts capital gains which are passed on through gratuitous transfers. Second, the maximum rate of tax applicable to capital gains is 4 annas in the rupee (i.e. 25 per cent) as against the 7 annas in the rupee (i.e. about 45 per cent) suggested by Mr Kaldor. It is generally recognized that if, in the case of a capital gains tax, tax liability is related to the realization of capital gains, the taxpayer naturally tends to defer realization, and 'if gratuitous transfer (whether in lifetime or in death) is not treated as realization, the taxpayer can postpone the payment of capital gains tax indefinitely.'² Experience in the U.S.A. suggests that because of this exemption nearly two-thirds of the capital gains remain untaxed. There is reason to believe that in India, where the joint-family system is still sufficiently entrenched in spite of the onslaughts of industrial advance and Western values, a much larger proportion of capital gains would not be taxed so long as this exemption persists. As regards the second departure, Mr Kaldor's proposal for the maximum rate of 7 annas in the rupee was linked with his other suggestion that the basic rate of income tax (as distinct from supertax) should be raised from 4 annas to 7 annas in the rupee. His idea was that it would simplify matters a great deal if capital gains were treated as income and taxed accordingly. The Finance Minister chose, however, to retain the basic rate of 4 annas for income tax, and he therefore fixed the maximum rate of capital gains tax also at 4 annas in the rupee. The fixation of the lower maximum has naturally meant that the proceeds will be lower than if the maximum suggested by Mr Kaldor were adopted. In fact, it should be possible to raise the maximum rate of capital gains tax to at least 30 per cent now that the current budget proposes to raise the rate of income tax on companies from 25 per cent to 30 per cent, for after all, the significance of a basic rate of income tax as distinct from super-tax rests on the provisions, which exist in the income-tax

¹ A detailed appraisal by the author of the capital gains tax appeared in *The Economic Weekly* of 8 December 1956 and *The Statesman* of Calcutta, 17 December 1956.

² Quoted from the editorial comments under the caption 'Not in Defence of T.T.K.' in *The Economic Weekly* of 8 June 1957.

legislation following the British practice, for the refund of income tax to shareholders in respect of distributed profits.¹

PERSONAL EXPENDITURE TAX²

The personal expenditure tax introduced through the current budget also differs from Mr Kaldor's proposal, and in two important respects. First, while Mr Kaldor proposed a straightforward relationship between tax liability and personal expenditure subject to the exemption of Rs. 10,000 per annum per adult, the tax introduced relates tax liability to income *in addition to* expenditure on personal consumption. Apart from the fact that this provision restricts the number of assesseees chargeable to expenditure and therefore brings down its yield, it creates an anomalous position in that if a person with a wife and two children has an assessable income of over Rs. 60,000 per annum, he is liable to the expenditure tax if his expenditure on personal consumption exceeds Rs. 34,000 but another person with an assessable income of, say, Rs. 50,000 will not be liable to the expenditure tax even if his personal expenditure were to exceed Rs. 34,000. Moreover, to have fixed the same exemption limit of Rs. 24,000 for a bachelor as for a person with a wife but no child will operate unduly in favour of the bachelor. The second important point of departure is that the rates of tax rise from 10 to 100 per cent whereas Mr Kaldor had suggested a rate schedule ranging from 25 to 300 per cent. Presumably, the reason why the expenditure tax has been introduced at these lower rates is that it was not considered immediately practicable to bring down the super-tax rates applicable to individuals to the level suggested by Mr Kaldor. But the fact remains that as a consequence the revenue from the expenditure tax cannot be as large as Mr Kaldor estimated.

WEALTH TAX

The case of the wealth tax is not simply one of dilution. Dilution has no doubt taken place in respect of (a) the minimum exemption limit, (b) the exemption of some types of assets and

¹ I must confess my inability to understand why the current budget does not raise also the maximum rate of income tax applicable to individuals from 25 per cent to 30 per cent. Unless this is done, how would an individual be given full credit for the 30 per cent paid by a company on his dividend income when he is liable to the maximum rate of 25 per cent? I don't think it is proposed to allow an offset against the individual's liability to supertax.

² See my P.P.S. on p. 204 *infra*.

(c) the aggregation of wealth for purposes of rate fixation. But it is not an unmixed dilution.

Mr Kaldor proposed that, to start with, persons with property valued at Rs. 100,000 or below should be exempted from the wealth tax, and as the administration gained in experience the limit could be brought down. The wealth tax now introduced specifies three separate exemption limits: Rs. 200,000 for individuals; Rs. 300,000 for joint families; and Rs. 500,000 for companies. The first two limits are cases of dilution, the third one of extension because it was Mr Kaldor's intention to subject corporate property not directly to the wealth tax but through its share-holdings. No doubt, the taxation of wealth under the new tax both as corporate property and then as share-holdings involves taxing the same property twice, and this amounts to discrimination against corporate property. But this sort of differentiation is not more indefensible than the differentiation which exists at present in charging companies to a non-refundable tax (known in India as corporation tax) on their profits. The fear, however, is that this tax might on the one hand operate against (a) accumulation of corporate reserves and (b) equity financing of corporate investment; and on the other hand in favour of loan financing. Besides, the taxation of companies amounts largely to a transfer of savings from the private to the public sector and not of resources which would otherwise have been consumed. The purpose served therefore by this part of the wealth tax will be to reduce the funds available to the private sector for investment. If this is one of the objectives the Government aimed at, a tax at the rate of one-half per cent on company assets will be an extremely ineffective measure indeed.

According to Mr Kaldor, 'for the sake of equity, as well as administrative efficiency, it is essential that the tax should be comprehensive, i.e. extending to all forms of property.'¹ He was keen on the inclusion of agricultural property and suggested a constitutional amendment, 'unless the procedure adopted in the case of estate duties of the States delegating the powers to the Centre could be repeated here.'² Under the new wealth tax, agricultural property along with items like life-insurance policies, coparcenary interest in joint-family properties, post-office deposits and deposit certificates, and household valuables including jewellery (subject to a maximum of Rs. 25,000) are

¹ *Report*, op. cit. p. 20.

² *Ibid.* p. 20.

not liable to the wealth tax. Not only that, these items are not to be treated as 'wealth' even for determining the total wealth with reference to which the rate of tax is fixed, i.e. these items are not aggregable for purposes of rate fixation. In other words, the more property one has in these exempted forms the more one saves in taxation, both because they are not chargeable to tax and also because the tax payable on the chargeable part of one's wealth is smaller in amount than if these exempted items were chargeable to tax.

There was perhaps some justification in exempting agricultural property, for under the Constitution only the States are entitled to levy taxes on agricultural property. It would perhaps have delayed the introduction of the wealth tax if the Centre were to await the States' consent to the Central taxation of agricultural property. But what the Centre was immediately competent to do was to make agricultural property aggregable for purposes of rate fixation. This would do away with part of the differentiation inherent in the present measure. As to the remaining differentiation, either the States could introduce a wealth tax on agricultural property at their respective levels (as the Government of the State of Kerala has already done) or they could delegate their powers to the Centre as had been done in the case of the estate duty.

As regards some other items exempted from the wealth tax, the justification for their exemption is more slender. This applies with particular force to life-insurance policies and post-office deposits and deposit certificates. If the idea is to encourage savings in these forms, the proper thing to do is to give direct incentives if they are deemed necessary. Tax incentives in the form of exemption operate regressively in two ways. Firstly, they are available to the class of property-holders who are chargeable to tax (i. e. who own greater wealth than those who are below the exemption limit) as against those who are not. Secondly, even among taxpayers, the greater the wealth of a taxpayer the greater is the benefit from such exemption, because the liability to tax increases at a progressive rate with the increase in wealth. These exemptions therefore militate against the objective of redistribution of property and income. Also, the argument that these exemptions will help to secure greater saving in the community is not very convincing when one remembers that the maximum rate of the wealth tax is only one and one-half per cent on the net value of total wealth.

The exemption of coparcenery interest in joint-family properties raises one important issue, an issue which is of relevance also to the present income-tax practice. The obvious justification for this exemption is that this coparcenery interest will be subject separately to the wealth tax as part of the joint-family property (although it has not been extended, as it should logically have been, to interest in corporate property). The objection to this exemption arises because it invites the splitting-up of property into coparcenery interest in joint-family property and individual property and thereby saving tax either through the operation of exemption limits or, if the property is very large and cannot therefore avoid the wealth tax altogether, through lower rates of tax chargeable when the property is split up among two distinct assessable entities than if it were to be treated as one composite property. To prevent such tax-avoidance it is suggested that the taxpayer should be allowed an offset against his total tax liability on total wealth (including the coparcenery interest in a joint-family property) to the extent of the tax paid by the joint family in respect of his coparcenery share. This provision should protect the taxpayer against double taxation and also prevent the tax-avoidance which is possible if total exemption is given.

It is also felt that the exemption granted in respect of household valuables is very liberal. If the intention is only to avoid the administrative expense involved in their valuation, the appropriate measure to adopt would be to accept the assessee's valuation in respect of household valuables so long as (a) they are below a certain value and (b) the taxation authorities have no reason to believe that the declared valuation is deliberately understated. Complete statutory exemption should as far as possible be avoided because experience in other countries suggests that statutory exemptions become avenues of tax-avoidance and in the long run create vested interests which are difficult to dislodge at a later stage. The guiding principle in imposing the wealth tax should be that it allows for a minimum of differentiation between various kinds of assets regardless of whether they are life-insurance policies, provident-fund balances, government securities or properties received as awards for gallantry.

Another feature of the new wealth tax which calls for comment is the requirement that the assets should be revalued every year. Now, one of the objections usually advanced against the wealth tax is that the annual revaluation of assets required for its

assessment is a task virtually impossible to perform with reasonable efficiency. That is why, the argument runs, however sound a scheme of annual taxation of capital, it very soon runs into difficulties and degenerates into some sort of differential outlay tax on various types of assets. It was with a view to avoiding, or at least reducing to the minimum, these administrative difficulties that Mr Kaldor suggested that, 'the best method or procedure is to follow ordinary accounting rules and to value each particular item of property at its "book value" until it is sold,¹ or disposed of gratis. The 'book value' means the current value of an asset at the time of the introduction of the tax or the cost incurred subsequent to its introduction. Under this procedure, valuation specifically for purposes of assessment has to be made '(a) initially when the tax is introduced and the personal accounts are set up; and (b) subsequently when the property is transferred to a different owner otherwise than by sale.'² Now, Mr Kaldor was aware that valuation at 'book value' instead of at current market value would mean that values assessed to the wealth tax would tend to lag behind current market values, and as a remedial measure he proposed that in fixing the schedule of rates for the wealth tax appropriate upward adjustment should be made on this account.

Mr Kaldor's proposal for basing the wealth tax assessment on 'book values' has the great merit of bringing the administrative task within manageable proportions. But his other suggestion, that to offset the tendency for 'book value' to lag behind current market value the rates should be raised appropriately, is open to the objection that it will apply capriciously to various assets irrespective of the actual lag (in time as well as value) in respect of each of the assets charged. An alternative to Mr Kaldor's suggestion, but perhaps somewhat more complicated, would be to continue assessing the wealth tax on the 'book value' until the asset in question is transferred by sale or otherwise and then reassess the tax on the difference in value discovered at the time of transfer, on the assumption that the difference was spread evenly over time unless the taxpayer can prove otherwise. In any case, to provide for annual valuation of property will be suicidal to the new tax, and the earlier the Government relents on it, the better.

¹ *Report*, op. cit. p. 25.

² *Ibid.* p. 15.

GIFT TAX

The general gift tax formed an important link in Mr Kaldor's scheme of comprehensive personal taxation, primarily because, with the personal expenditure tax on the statute book, much tax-avoidance would be possible through concealing personal expenditure in gifts if the latter are not chargeable to tax. Also, since under Mr Kaldor's scheme capital gains were to be treated as realized not only when assets are transferred on sale but also when transferred by way of gift or bequest, the taxation of the latter form of transfer, which is eminently justified in terms of equity, representing as it does an accretion of economic power, becomes administratively an easy and economical method of raising revenue. These considerations apart, a gift tax is essential to have as a complement to the taxation of transfers on death.

In India, transfers on death are taxed through an estate duty with rates which are very low compared to those prevailing in many other countries of the world. Mr Kaldor suggested the replacement of the estate duty by a general gift tax payable on all gratuitous transfers, whether by way of gift or bequest, in excess of Rs. 10,000 for any single recipient. Mr Kaldor's proposal derives from two arguments. First, the estate-duty form of taxation is based on 'an antiquated conception', because 'the true incidence of inheritance taxes falls on the recipients of the inheritance, and not on the deceased.'¹ Second, 'there is no justification in equity for a difference in treatment as between gifts *inter vivos* and the receipt of legacies or bequests.'² Hence the need for a single progressive tax on all gratuitous transfers.

It is hoped that the omission of the gift tax from the proposals of the current budget does not reflect the Government's calculated decision against such a tax altogether. As stated above, the absence of the gift tax creates a wide loophole for the avoidance of the expenditure tax, and if the intention is to see the latter operate effectively either as a revenue collector or as a disincentive to ostentatious spending, the introduction of the gift tax cannot for long be postponed.

TAX RETURNS

It is hoped also that in prescribing the returns to be completed for assessment for income, wealth, expenditure and also capital-

¹ *Report*, op. cit. p. 16.

² *Ibid.*

gains taxes, the taxpayer will be required to submit one comprehensive return, instead of separate returns for each of the taxes. This would be advantageous not only to the taxpayer in terms of the saving in time and expense involved in submitting separate returns entailing considerable duplication, but also to the tax authorities because they would be able to cross-check the entries in one comprehensive return more readily than if the information were spread over a number of separate (but piecemeal) returns.

P.P.S.

After this postscript was written it was reported in the press (*The Times of India*, 18 July 1957) that the Finance Minister had proposed a number of important structural changes in the expenditure tax. The most important change proposed is to drop the proviso which says that the expenditure tax will be payable by an assessee only if his total income exceeds Rs 60,000. Another modification proposed is that the expenditure limit should be altered to Rs 30,000 for an individual (including wife and one child) and an additional Rs 5,000 for every additional dependant in place of the originally proposed limit of Rs 24,000 for an individual (including wife only) and Rs 5,000 for each of *two* dependants.

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