Chapter - 1

Introduction

Macroeconomic policy may be defined as a programmer of action under taken to control, regulate, and manipulate macroeconomic variables to active the macroeconomic goals of the economy. In the wards of Brooks and Evans “macro economic policy can be though of as an attempt by the authorities to achieve particular target levels of certain major economic Aggregates”

1.1 The need for and advent of Macroeconomic policies:

Macroeconomic problems have always been there ever countries began the Endeavour to improve their living conditions but the roll of government in managing the economy and use of macroeconomic policies to solve the macroeconomic problems are of recent origin. Until the great depression of the 1930 there was nothing like macroeconomic policy. Classical economist did not favors the government intervention in economic system. However the great depression (1929-1933) shattered classical doctrine as it could often neither an explanation nor a solution to the devastating and unprecedented economic problems caused by the great depression.

It was Keynes who highlighted and advocated the government role for economic management to active growth and stability Keynes view gained prominence in the post second world war period, specially in the reconstruction of the War-ravaged economies and described that government may play a significant role of the prime- mover and con accelerate the pace of economic growth reduce unemployment and stabilize the economy though its fiscal measures. “many early enthusiast of the Keynesian approach belied that fiscal policy was like a knob they could turn to control the pace of the economy”

Some economist believed that “the need for macroeconomic policy arise because the economic system does not adjust appropriately to the shocks to which it is constantly subjected” Major objective of macroeconomic policies can be summarized as fallows
Economic growth.

- High rate of employment.
- Price stability.
- Economic equity.
- Stabilizing balance of payment.

1.2 The instruments of macroeconomic policy:

Given the current policy structure a policy or a combination thereof has to be chosen from a set of policies including

(a) Fiscal policy
(b) monetary policy
(c) income policy.

Monetary policy instruments include

(i) central bank rate or discount rate.
(ii) open market operations
(iii) cash reserved ratio (C.R.R.)
(iv) selective credit control.

Fiscal policy instruments include

(i) public expenditure
(ii) taxation
(iii) public borrowings
(iv) deficit financing

The change made in fiscal target variable works mainly through the real variables like disposable income, consumption, expenditure savings and investment and wealth holding of the people.
It is now widely accepted that the state has a sine qua non in the regulation of economic activity along the desired lines. Fiscal policy is traditionally concerned with the determination of income and expenditure policy. However, in recent times with the expanding role of state with particular reference to the need for a rapid economic growth, public borrowing and deficit budgeting have also become a part of fiscal policy. The crux of an effective fiscal policy is related to the policy decisions with regard to the entire financial structure of the government such as expenditures, loans, tax revenue and debt management etc. They all are kept in a proper balance so as to active the best possible results in terms of economic objectives. In the ultimate sense, fiscal policy tries to active its objectives by regulating the working of the market mechanism while retaining the mechanism itself. In short the extent of its success entirely depends upon factors such as marking of market focus, economic stability of the economy, proper use of its tools, the flow of foreign capital and trade.

1.3 Meaning of fiscal policy

In the simple word, fiscal policy concerns itself with the aggregate effect of government expenditure and taxation on income, production and employment. In other wards, it refers to the instruments by which a government tries to regulate or modify the economic affairs of an economy keeping in view certain objectives.

The concept of fiscal policy has been defined by different economists as follows.

- According to Mrs. Ursula hicks “fiscal policy in concerned with manner in which all the different elements of public finance while still primarily concerned with carrying out their own duties (as the first duty of a tax is to raise revenue) may collectively be geared to forward the times of economic policy”.

- Arthur Smithies defines fiscal policy, “As a policy under which the government uses its expenditure and revenue programme to produce desirable effects and avoid undesirable effects on the national income, production and employment” this definition tells about the objectives and tools of fiscal policy.

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1 Mrs. Ursula Hicks; Public Finance
Prof. Gardner Ackley defines it as, “fiscal policy involves alterations in government expenditures for goods and services of the level of tax rates. Unlike monetary policy, these measures involve direct government entrance in to the market for goods and services (in case of expenditure) and a direct pact on private demand (in the case of taxes)

Honey and Johnson m. Define fiscal policy as “changes in government expenditure and taxation designed to influence the pattern and level of activity”

According to G.K. Shaw, “we define fiscal policy to include any design to change the price level, composition or timing of government expenditure or to vary the burden, structure of frequency of the tax payment”

U. N. report on taxes and fiscal policy says, “fiscal policy is assigned the central task of wrestling with the pitifully low out put of under developed countries, sufficient savings to finance economic development programmers and to set the stage for more vigorous public investment activity”

In the views of American economic association, “fiscal policy should mean the policy which concerns itself with aggregate effects of government expenditure and taxation on income, production, and employment”

1.4 Traditional view of fiscal policy

The classical economists has a firm belief in the policy of laissez- faire. The says law of market was the corner- stone of all economic policies which propounds that supply creates its own demand and as a result, there is no question of general over- production or involuntary unemployment they intended to the size of the public sector by reducing the functions of the government to the minimum possible so that the operation of market mechanism is not hindered. Thus, they thought that the free operation of market for as would achieve full employment and ensure an optimum allocation of recourse in a country.

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2 Honey, I. and Johnson, M. An Introduction to Macroeconomics.
3 Shaw, G.K.; ‘An Introduction to The Theory of Macroeconomic Policy’.
To them, taxes were nothing more than unproductive expenditures resulting in wrong diversion of recourse, they felt that fiscal arrangements should not go beyond the point where the optimum allocation gets disturbed. They consider it more desirable that the government should perform only minimum essential function and not interfere in the working of the economic system. In other words, they repeatedly stressed that the fiscal policy should be neutral in its impact on economic system. For the principle of sound finance they advocated that government is the best which spends the least and impose the lowest amount of taxes, they laid down certain conditions as;

(a) Government should spend the last and tax the little.
(b) Taxation should have minimum adverse effect on production.
(c) Public expenditure should be on productive fields.
(d) There must be a balanced budget.

Further, the traditionalists had the confirmed opinion regarding the principle of a balanced budget and surplus of deficit budget as undesirable, Prof. A. K. Hansen envisages two things for that principle of fiscal neutrality as:

(i) The reduction of government spending to a certain limit and
(ii) A tax structure that leaves the product and factor prices undisturbed.

Similarly P. A. Samuelson also favoured fiscal neutrality on the following grounds:

(i) Annually balanced budget should be at a low level of expenditure.
(ii) Public debt is as evil and a burden, thus it should be avoided at all costs.
(iii) Nation’s budget should be administered on the same lines as a private budget.
(iv) Tax system should not cause distributional changes.
(v) Taxation should fall on current consumption so that private savings and investments are encouraged resulting in higher rate of growth

1.5 Modern views of fiscal policy

Prof. Keynes, A.P Lerner, G. Mydral gave a new shape to the fiscal policy. They refuted the classical economists’ concept that supply creates its own demand. As such there is no
possibility of unemployment and the equilibrium in the economy. The same are automatically achieved because of market forces, asserted say.

However, Keynes believed that in on advance economy, the propensity to consume tends to diminish as income increases. In other words propensity to save increases with increase in income. The gap between less consumption and larger savings results in lowering demand for goods and services produced at one time. Which leads to disequilibrium in the economy. Therefore to maintain equilibrium level of income and employment, it is prerequisite to offset the effects of decrease in demand and its impact on output due to decrease in consumption by a corresponding increase in the public expenditure. Therefore, it is the prime duty of the government to increase expenditure directly by undertaking public works programme on a large scale. In this manner modern economists stress that the government has to play a positive role to regulate and control the economy by decisive economic activities, they call it the principle of functional finance. To put it in a different sense, such financial activities are called fiscal policy which are undertaken to correct is either deflation or inflation.

1.6 Taxation & Fiscal Policy

Taxation is a powerful instrument of fiscal policy in the hands of public authorities which greatly affect the changes in disposable income, consumption and investment. Taxation plays a critical and pivotal role in the process of advancement and growth of any country. Objectives of the tax policy of any country are akin to its general economic policy. Taxes constitute major sources of revenue for the government. Taxes are levied so that investment is made in the resources to enable a country to develop, grow and make progress. A sound tax system is vital for development of the public finances of any country. The main objectives of tax policy can be said to be allocative, distributional and stabilization (Musgrave, 1973, p.6-21). Due to the importance of taxation in fiscal policy, it is often said that economic history of a country is determined by its fiscal history (Schumpeter, 1954, p.7).

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4 Allocative function of tax policy is linked with the process by which utilization of resources is divided between private and social goods. Distributional function concerns distribution of income and wealth and stabilization policy is related to a set of policies for maintaining high employment, a reasonable degree of price stability and an appropriate rate of economic growth.
India has a three-tier federal structure (the Union Government, the State Governments and the Urban/Rural Local Bodies). The power to levy taxes and duties is apportioned between the Union Government and the State Governments in accordance with the provisions of the Indian Constitution. The State Government may further delegate any of its fiscal powers to local authorities. Tax system in India comprises of direct taxes as well as indirect taxes⁵. Except for land revenue and agricultural income tax, all other direct taxes are levied and collected by the federal government. At the federal level, Central Board of Direct Taxes (CBDT) has been given responsibility of all matters relating to various direct taxes in India and the Board derives its authority from Central Board of Revenue Act, 1963.

In view of various changes within and outside, developing countries implemented a series of economic reforms during the 1980s and the 1990s. During these decades, reassessment of the role of the government in economic development took place, which led to a shift in favour of assigning a greater role to private sector. This necessarily required re-examination of the structure of Indian tax system and fiscal policy. In this regard the present thesis is an attempt to critically examine the fiscal policy of India with special reference to personal income tax administration.

1.7 Origin of Income Tax in India

1.7.1 Ancient Period

There is enough evidence to show that taxes on income in some form or the other were levied even in primitive and ancient communities. References to taxes in ancient India are found in “Manusmriti” and “Kautilya’s Arthashastra”. Manu the ancient sage and law giver stated that king should levy taxes according to sastras. He advised that taxes should be related to income and should not be excessive. He laid down that traders and artisans should pay 1/5th of their profits in gold and silver, while the agriculturists were to pay 1/6th, 1/8th and 1/10th of their produce depending upon their circumstances. The detailed analysis given by Manu on the subject clearly shows the existence of a well planned

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⁵ While direct taxes mainly consist of personal income tax, corporation tax, wealth tax, land revenue and agricultural income tax, indirect taxes comprise mainly of customs, union excise duties, service tax, state excise duty, stamp and registration fees, sales tax, taxes on vehicles and entertainment tax.
taxation system, even in ancient times. Kautilya’s “Arthasastra” was the first authoritative text on public finance, administration and the fiscal laws. Collection of income tax was well organized during Mauryan Empire. Schedule of tax payment, time of payment, manner and quantity were fixed according to Arthasastra. It is remarkable that the present day system of taxation is in many ways similar to the system of taxation given by Kautilya 2300 years ago.

1.7.2 Pre Independence Period (1886-1947)

Income tax in its modern form was introduced in India for first time in 1860 by the British Government to overcome the financial crisis following the events of 1857. Initially Government introduced it as a temporary measure of raising revenue under the Income Tax Act 1860 for a period of five years. Different tax rates were prescribed for different heads of income. In the year 1867, it was transformed as licence tax on trade and profession. In the year 1869, the licence tax was replaced by Income Tax again. The assessments were made on arbitrary basis leading to inequality, unpopularity and widespread tax evasion. Income Tax was withdrawn in the year 1874. After the great famine of 1876-78, the Government introduced local Acts for income tax in different provinces. With several amendments these Acts remained in force till 1886. Thus, the period from 1860 to 1886 was a period of experiments in the context of income tax in India.

In 1886, a new Income Tax Act was passed with great improvements than the previous Acts. This Act with several amendments in different years continued till 1918. In 1918, a new Act was passed repealing all the previous Acts. For the first time, this Act introduced the concept of aggregating income under different heads for charging tax. In 1921, the Government constituted “All India Income Tax Committee” and on the basis of recommendation of this committee a new Act (Act XI of 1922) was enacted. This Act is a landmark in the history of Indian Income Tax system. This Act made income tax a central subject by shifting the tax administration from the Provincial Governments to the Central Government. During this period the Board of Revenue (Central Board of Revenue) and Income Tax Department with defined administrative structure came into existence.
1.7.3 Post Independence Period

The Income Tax Act 1922 continued to be applicable to independent India. During the early post-independence period, the Income Tax legislation had become very complicated on account of innumerable changes. During this period tax evasion was wide spread and tax collection was very expensive. In 1956, the Government of India referred the Act to a Law Commission to make the Income Tax Act simpler, logical and revenue oriented. The Law Commission submitted its report in September 1958 and in the meantime the Govt. also appointed a Direct Taxes Administration Enquiry Committee to suggest the measures for minimizing the inconvenience to the assesses and prevention of tax evasion. This committee submitted its report in 1959. The recommendations of the Law Commission and the Enquiry Committee were examined and extensive tax reform programme was undertaken by the Government of India under the supervision of Prof. Nicholas Kaldor. The Income Tax Bill 1961, prepared on the basis of the Committee's recommendations and suggestions from Chamber of Commerce, was introduced in the Lok Sabha on 24.4.1961. It was passed in September 1961 by Lok Sabha. The Income Tax Act 1961 came into force on April 1, 1962. It applies to whole of India including the state of Jammu and Kashmir. It is a comprehensive piece of legislation having 23 Chapters, 298 Sections, various sub sections and 14 schedules. Since 1962, it has been subjected to numerous amendments by the Finance Act of each year to cope with changing scenario of India and its economy. Moreover the Central Board of Direct Taxes is empowered to amend rules and to clarify instructions as and when it becomes necessary.

Besides this, amendments have also been made by various Amendment Acts e.g. Taxation Laws Amendment Act 1984, Direct Taxes Amendment Act 1987, Direct Taxes Law (Amendment) Acts of 1988 and 1989, Direct Taxes Law (Second Amendment) Act 1989 and at last the Taxation Law (Amendment) Act 1991. As a matter of fact, the Income Tax Act 1961 has been amended drastically. It has therefore become very complicated both for administration and taxpayers.
1.8 Recent Tax Reforms

The economic crisis of 1991 led to structural tax reforms in India with main purpose of correcting the fiscal imbalance. Subsequently, the Tax Reforms Committee headed by Raja Chelliah (Government of India, 1992) and Task Force on Direct Taxes headed by Vijay Kelkar (Government of India, 2002) made several proposals for improving Income Tax System. These recommendations have been implemented by the government in phases from time to time. As regarding the personal income tax, the maximum marginal rate has been drastically reduced, tax slabs have been restructured with low tax rates and exemption limit has been raised. In addition to this, government rationalised various incentive provisions and widened TDS scope. In case of corporate tax, the government has reduced rates applicable to both domestic and foreign companies, introduced depreciation on intangible assets and rationalised various incentive provisions. Some new taxes have been introduced such as Minimum Alternative Tax and Dividend Distribution Tax, Securities Transaction Tax, Fringe Benefit Tax and Banking Cash Transaction Tax. However, Fringe Benefit Tax and Banking Cash Transaction Tax were withdrawn by Finance Act, 2009.

The Income tax administration was restructured with effect from August 1, 2001 to facilitate the introduction of computer technology. Further, keeping in mind the global developments, the department has made considerable efforts for reforming the tax administration in recent years. Some important measures in this direction are introduction of mandatory quoting of Permanent Account Number (PAN), e-filing of returns, e-TDS, e-payment, Tax Information Network (TIN), Annual Information Return (AIR) for high value transaction, Integrated Taxpayer Profiling System (ITPS), Refund Banker Scheme in certain cities etc. The main objective of these reforms has been to enhance tax revenue by expanding the taxpayer base, improving operational efficiency of the tax administration, encouraging voluntary tax compliance, creating a taxpayer friendly atmosphere and simplifying procedural rules.
1.9 Scheme of Personal Income Taxation in India

The constitution authorises the Central Government to levy and collect tax on income other than agricultural income under Income Tax Act, 1961. The proceeds of income tax are shared between the Union and the State Governments as per the recommendations of the Finance Commission. Income tax is chargeable on the total income of the previous year of a person at the rates prescribed by Finance Act every year.

Income Tax can be classified in two parts viz. Personal Income Tax and Corporate Tax. Income tax levied on individuals, hindu undivided families (HUFs), firms, association of persons (AOPs), body of individuals (BOIs), local authorities and artificial juridicial persons is called Personal Income Tax and income tax levied on companies is called Corporate Tax. The incidence of tax on any person depends upon the place of origin of income and the residential status of the taxpayer. According to their residential status, persons have been classified into three broad categories:

1. Resident
2. Resident but not ordinarily resident
3. Non-Resident

The residential status of an assessee is ascertained with reference to each previous year. A non-resident is required to pay tax in respect of income received or deemed to be received in India and accrued or deemed to accrue to him in India. A resident of India is charged to tax in respect of all the income i.e. received or deemed to be received in India or outside India, accrued or deemed to accrue in India or outside India during the relevant previous year. However, the total income of a resident but not ordinarily resident is not to include income which accrues to him outside India, unless it is derived from a business or profession controlled in India. For the purpose of computing total income and charging tax thereon, income from various sources is classified under the following heads:

1. Income from salary
2. Income from house property
3. Profits & Gains of business or profession
4. Capital gains

5. Income from other sources

These five heads of income are mutually exclusive. If any income falls under one head, it cannot be considered under any other head. Income under each head has to be computed as per the provisions under that head. Aggregate of assessable income of all heads, after giving effect to the provisions for clubbing of income and set off and carry forward of losses, is called the gross total income (GTI). Out of GTI, deductions under chapter VI-A are allowed and the balance amount left is called total income. Gross amount of income tax payable is calculated on total income according to the rates prescribed by the Finance Act for the relevant assessment year and the rates prescribed under different sections of the Act. From the gross tax payable, tax rebate under Section 88E and relief under Section 89(1) is to be deducted. The balance is the net tax liability subject to any advance tax paid or tax deducted or collected at source.

Every individual and HUF has to furnish the return of his income if his total income before allowing deduction under Chapter VI-A exceeds the maximum amount which is not chargeable to income tax. An essential feature of the Indian Income Tax law is that it provides various tax incentives to ensure savings, development of particular industry and areas, exports etc. in the desired manner. Income tax is levied at a flat rate in case of corporate, firms and body of individual assesses. Income tax is levied on slab system in case of individuals and HUFs assesses. Thus, the income tax system is progressive i.e. the applicable tax rate increases as total income increases.

1.10 Need for the Study

Since India is a developing country and the objective of continuous and speedy development will be achieved only with the simultaneous growth of national income, production, employment, public expenditure, public revenue and general price level in its appropriate level, it can be fulfilled by the fiscal policy which include any design to change the price level, composition or timing of government expenditure or to vary the burden, structure or frequency of the tax revenue and public expenditure. The most significant cause of economic backwardness is the existence of the vicious circle of
poverty in a poor country because the lack of sufficient resources for promoting development. So the increasing investment expenditure is most important phenomena for economic development. So main purpose is that to maintain the investment expenditure programme in such a manner which may help to achieve the long term and short term objectives of economic development. It indicates the powerful importance of fiscal policy for sustainable growth in a developing economy like India.

Because taxation policy plays a measure role in fiscal policy and in India a large part of the tax revenue comes from personal income tax therefore this study entitled “CRITICAL ANALYSIS OF FISCAL POLICY OF INDIA SINCE 1971: WITH SPECIAL REFERENCE TO PERSONAL INCOME TAX ADMINISTRATION” will be fruitful in making suggestions on the fiscal policy or broad based personal income tax aspect for a developing economy like India.

1.11 Objectives of the Study

The objectives of the present study are as follows:

- A critical review of macroeconomic policy in general.
- A critical review of macroeconomic policy in India.
- A critical review of fiscal policy structure of India.
- A critical review of taxation structure of India.
- A critical review of structure of direct taxation in India.
- A critical review of structure of personal income taxation in India.
- To find out the trend of Tax/GDP ratio in post reform period.
- To see the tax buoyancy in pre and post reform period
- To find out the CAGR of various tax revenues in pre and post reform period
- To test the difference of mean value of tax revenue in pre and post reform period
- To test the variance of tax revenue in pre and post reform period.

1.12 Organization of the Thesis

The thesis is divided into eight chapters. The first chapter is introductory in nature. The second chapter presents a brief overview of Indian fiscal system. The third chapter
devoted to review of literature. Fourth chapter related to taxation policy in India. The fifth chapter discusses the Income tax administration in India. The sixth chapter discusses the objective of the study and methodology used in data analysis. Chapter seven devoted to data analysis and hypothesis testing. And the last chapter is summarizing the whole thesis with finding and conclusion.