

AN EXAMINATION OF A PROPOSED SELF-  
ENFORCING INCENTIVE TAX SYSTEM  
FOR UNDERDEVELOPED  
COUNTRIES

By

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## PREFACE

This thesis is concerned with examining a proposed self-enforcing tax system for underdeveloped countries. The structure of the proposed system is studied and compared to a similar structure which has been in operation in India since 1957. The proposed system appears to offer advantages of: (1) a large degree of self-enforcement in the tax structure through interlocking taxes, and (2) attractive incentives to private undertakings.

Research facilities of the Library of Congress and the District of Columbia Library were especially valuable in preparing this study. I wish to thank Mr. N. Ratwnai, Economics and Finance Attache of the Embassy of India in Washington, D. C., for his assistance in obtaining much needed data.

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## CHAPTER I

### INTRODUCTION

Economic development as a national goal has placed a staggering burden on the tax systems of many countries. The task of financing programs of economic development has made it necessary to try to make the tax systems in these countries more effective.

As recently as 1965 Ursula Hicks observed that the complete financing of a program of economic development had not been treated in the public finance literature.<sup>1</sup> Hicks' short work on the subject deals with the complete program of planning, finance and expenditure but omits the concrete details of the taxes to be levied. A specific comprehensive tax system geared to the needs of developing countries has been offered by Professor Benjamin Higgins.<sup>2</sup>

Higgins calls his proposal an "incentive, self-enforcing tax system." It is based primarily on the work of Nicholas Kaldor. The Kaldor plan, presented in a report

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<sup>1</sup> Ursula K. Hicks, Development Finance (New York: Oxford University Press, 1965), pp. iii-viii.

<sup>2</sup> Benjamin Higgins, Economic Development (New York: W. W. Norton and Company, Inc., 1959), pp. 474-79.

to the federal government of India, was for a closed system built around a tax on all expenditure. The system draws upon ideas discussed by John Stuart Mill, Alfred Marshall and Irving Fisher.<sup>3</sup>

The Higgins proposal uses a set of interlocking, complementary taxes which are self-enforcing to the extent that underreporting of one tax results in a higher liability for another tax. The system provides incentives to save by a provision that investment in certain approved projects is exempt from taxes or a reduced tax rate is applied to assets held in specified form.

It is the purpose of this study to examine the Higgins proposal within the framework of public finance theory and come to some meaningful conclusions about its adequacy.

The thesis is divided into five parts:

- One: Chapter I details the background of the proposal with a brief review of the needs for and sources of capital formation. This includes the mobilization of domestic resources.
- Two: In Chapter II the proposed tax system, its components administrative detail, theoretical bases, goals, advantages, and disadvantages are outlined and it is subjected to some evaluation.

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<sup>3</sup> Irving Fisher, Constructive Income Taxation (New York: Harper & Brothers, 1942), pp. 39, 101.

Three: The Higgins proposal is compared to the tax system of a specific country. India was selected because it has enacted into its tax laws some of the features recommended by Higgins. Possible contributions to capital formation are explored.

Four: Economics of welfare in the Higgins System are studied.

Five: Summary and Conclusions.

#### BACKGROUND

Experience shows that in relation to the needs of a program of economic development, the resources available in underdeveloped countries are meager. The conditions of low per capita output or product and low per capita incomes indicate that the resources readily available in such a country will be small. The task of mustering these scant resources is forbidding and establishing priorities to allocate available resources compounds the difficulties.

The national output in underdeveloped countries is almost entirely consumed. Little is left for investment and a low level of investment means low per capita incomes. Existing per capita incomes are very low, approaching subsistence levels, and this reveals a low capacity to save. Reducing consumption is a slow and difficult approach to raising investment and per capita incomes. A more hopeful solution is to raise output, hold consumption fairly constant, and invest a large portion of the increased output.

Since no individual is able to raise the national level of investment, government must accept responsibility for the burden. The simplicity of this solution is an illusion. The implementation of such a policy requires the planning of projects as well as setting priority between them. The sticky business of finance must also be faced. How is the finance to be arranged by which a country can pay for a program of economic development? A number of alternatives are possible. The principal ones are:

- (1) Borrow from foreign governments (foreign aid),
- (2) Borrow from foreign private sources,
- (3) Finance by inflation,
- (4) Finance by increased taxation.

Our concern will be financing by increased taxation. Choices (1) and (2) require decisions that are beyond the control of the country striving for development and when needed most these sources may be most reluctant to participate. Choice (3) involves severe economic dislocation domestically and possible economic isolation internationally.

What is the present condition of taxation at the national level in the underdeveloped countries? Generally it is inadequate to the task of securing the needed share of the nation's resources for economic development. A recent study found the following undesirable conditions:<sup>4</sup>

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<sup>4</sup>Joseph P. Crockett, "Common Obstacles to Effective Tax Administration in Latin America," Problems of Tax Administration in Latin America (Baltimore: The Johns Hopkins University Press, 1965), pp. 1-26.

- (1) A multiplicity of taxes poorly enforced,
- (2) No official compilation of tax laws,
- (3) No comprehensive regulations,
- (4) Absence of taxpayer's books and records,
- (5) Lack of discretionary powers of adjustment by  
the tax authorities,
- (6) High levels of fraud and corruption,
- (7) Non-unified tax systems,
  - (a) Multiple agencies to administer taxes,
  - (b) Multiple agencies to spend taxes,
- (8) Participants in tax receipts,
- (9) Sale of tax rights.

Aside from the problems of raising revenue, the tax system is expected to contribute to the stability of the economy which can be a monumental task with the situations that exist. Development retarding influences are strong. These take the form of capital outflow, luxury consumption, investment in traditional high-unit profit industries and inflation.

#### THE ROLE OF CAPITAL FORMATION IN ECONOMIC DEVELOPMENT

Capital is a versatile and dynamic factor in the development process which is not matched by any other ingredient in the growth process.<sup>5</sup> Capital formation, the

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<sup>5</sup> Charles P. Kindleberger, Economic Development, 2nd ed. (New York: McGraw-Hill Book Company, Inc., 1965), pp. 83-87.

surplus of output over consumption, leads to increased capacity and greater increases in output in subsequent stages. Capital formation leads to growth in incomes, permitting increased saving (investment) which increases capital, and this leads to further growth in incomes.<sup>6</sup>

Capital formation in developing countries depends on (1) increasing the level of saving, (2) increasing the level of investment and (3) channeling investment into the strategic growth sectors of the economy. The first step in implementing these goals is the control of luxury and non-essential consumption spending.

The sheer poverty of underdeveloped countries makes the raising of the propensity to save, as well as the inducement to invest a necessary part of fiscal policy.<sup>7</sup>

Restraints on consumption are essential to a program to increase saving. These restraints may be voluntary savings through banks, or collective saving through taxation.

Raising the level of saving refers to the general level of savings, for a country as a whole, not the level for an individual or class. Raising the level of investment means increasing it in the absolute sense. This could include mobilizing domestic savings invested in the stocks and bonds of advanced countries, as well as new saving. The most immediate prospect for increasing investment is by attracting

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<sup>6</sup>Ibid., pp. 457-73.

<sup>7</sup>Higgins, p. 474.

it from abroad in the form of foreign aid, loans from foreign governments and private foreign investment. One view is that the initial steps should be taken between governments in the form of aid and loans; then as opportunities are created and private investment attracted these could be phased out and most fields left to private investment.<sup>8</sup>

Channeling resources to capital formation is a knotty problem. Government will probably be the agent for channeling investment in developing countries. Foreign entrepreneurs can be controlled by license requirements. Domestic entrepreneurs will probably have to seek financing from a development bank which operates with government funds so government approval is essential.<sup>9</sup> Control of the source of finance provides government with the means for enforcing investment priorities. Where there is savings in the hands of private entrepreneurs there is the problem of preventing them from investing in residential housing and luxury imports as well as in domestic industry producing substitutes for such goods.<sup>10</sup> Positive checks against certain types of spending must be provided as well as positive inducements to invest in certain projects.<sup>11</sup>

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<sup>8</sup> Ibid., pp. 457-73.

<sup>9</sup> Kindleberger, p. 96.

<sup>10</sup> Ragnar Nurkse, Problems of Capital Formation in Underdeveloped Countries (Oxford: Basil Blackwell, 1955), p. 117.

<sup>11</sup> Kindleberger, p. 102.

## FORMING CAPITAL AND ECONOMIC DEVELOPMENT

## Mobilizing Domestic Resources

The process of development is inevitably very costly, so that it is just as important to have a good financial plan, making optimal use of financial resources, as it is to have a good economic plan, making optimal use of the real resources available. What the nature of a good financial plan will be turns very largely on two factors: first, the character of the country and its particular economic potentialities, and secondly, the degree of development already attained when the development exercise starts.<sup>12</sup>

Several easy paths to development have been proposed. These "primrose paths," always include an "up by the bootstraps" approach which emphasizes increasing productivity per manhour and disguised unemployment in agriculture. These are valid considerations but alone they are too weak to provide the momentum to push the economy to full blown development and they ignore the severe sacrifices required of the populace. A second approach is to "finance by inflation." Allowing prices to rise results in forced saving because of consumption foregone. Such a policy favors speculative enterprises and results in rising costs in export industries. A third plan is "pump priming" in which the government prints money and pours it into the economy as a stimulant. A fourth approach is the ever popular "confiscation of foreign assets." In most countries this

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<sup>12</sup>Hicks, p. 2.

is a mirage because the total value of foreign assets in the country may be very little. Such action also entails economic isolationism because foreign governments and foreign investors become wary. Management personnel of the confiscated enterprises may leave and the assets may become almost useless.<sup>13</sup>

#### INCREASED TAXATION

Non-inflationary financing of the greatest part of economic development by mobilizing resources within a country depends on the system of taxation. Taxes make such a positive contribution because:<sup>14</sup>

- (1) They are the most efficient way of transferring command over resources to the government.
- (2) Private saving may be inadequate so it must be backed up by public saving.
- (3) Taxes narrow the gap between available incomes of the very rich and the very poor.
- (4) Taxes can provide incentives for backward people to come out of isolation and develop a modern economy. The experiences of Japan

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<sup>13</sup>Higgins, p. 252.

<sup>14</sup>Hicks, pp. 67-68.

and Formosa indicate that payment of taxes in kind (staple crops or foodstuffs) may be most advantageous in the early stages of development. As a money economy develops, with rising prices, taxpayers will demand that income tax payments be made in cash.

- (5) Taxes are the most important instrument available for controlling the pressure on consumers' goods. Taxes drain off sufficient additional incomes to bring the total into equilibrium with available supplies of goods.

For these reasons tax policy should be a strong and vigorous factor in any plan for development but experience shows that it is almost without exception weak and ineffective in the underdeveloped countries. The situation seems so dismal that one observer has written in frustration, "Will the underdeveloped countries never learn to collect taxes?"<sup>15</sup>

#### INCREASED INVESTMENT

It is not sufficient merely to have the resources available for a program of economic development. These

<sup>15</sup>Nicholas Kaldor, "Will the Underdeveloped Countries Learn to Tax?", Foreign Affairs, KLI (Jan., 1963), p. 414.

resources must be utilized to increase the level of investment in the economy so that the maximum increase is secured with the least wastage.

Investment has different effects depending on its form and the source of finance. It is useful to distinguish three cases. These are:<sup>16</sup>

- (1) Private investment from saving,
- (2) Public investment financed by borrowing from the public,
- (3) Public investment financed by taxation.

Private investment financed from private saving presents two problems in an underdeveloped country. First, this kind of investment needs to be diverted from the traditional forms; e.g., jewelry, land, and cattle, so that it can be used in high priority development projects.<sup>17</sup> Light and medium manufacturing industries could be a ready outlet for small investors. Second, the size of the saving stream needs to be increased. The best hope for its increase is probably the retention of an increasing share of profits in individual firms for expansion purposes.

Financing public investment by borrowing from the public can be an important aspect of capital formation when the

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<sup>16</sup>Hicks, p. 47.

<sup>17</sup>A. H. Hanson, Public Enterprise and Economic Development (London: Routledge & Kegan Paul Ltd., 1959), pp. 62-71.

investment desired is rail lines, port facilities, and electric power projects. This kind of financing is appropriate to developing such strategic capital goods as cement, glass, and steel.<sup>18</sup>

#### TAXATION FOR DEVELOPMENT

Selection of the most appropriate taxes for a program of economic development should take into consideration (1) the incidence of taxation, (2) the income distribution within the particular country, (3) the effect of the expenditure of tax revenue, (4) disincentive effects of the imposition of the tax, and (5) any special problems of administration.

Indirect taxes; (1) import duties, (2) excise duties on domestic manufactures, (3) sales and other related taxes, and (4) taxes on services or use of certain capital goods, are very important in developing countries. Typically, the most important of these from the amount of revenue collected is import duties.<sup>19</sup> A serious shortcoming of the indirect taxes, particularly import duties, is that they tend to be regressive and thus tend to thwart other programs aimed at narrowing the income gap. Such taxes are favored in developing countries because of the ease of collection.<sup>20</sup>

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<sup>18</sup>Raja J. Chelliah, Fiscal Policy In Underdeveloped Countries (New York: The MacMillan Company, 1960), pp. 57-58.

<sup>19</sup>Hicks, p. 70.

<sup>20</sup>Ibid., pp. 71-73.

Sales and turnover taxes are heavily relied upon in most developing countries. Administration of these is very difficult where retailers deal by the roadside, often in barter, and lack accounting records. Turnover taxes, low rate levies on the value of goods as they are passed from firm to firm, are business taxes but firms usually add the amount of the tax to their prices so they become in effect general sales taxes. Two distinct disadvantages of this kind of tax are the tendency for it to be pyramided thus raising prices the consumer has to pay and the discrimination competitively in favor of integrated firms which process a product from its raw condition to its finished or semi-finished state. A refined type of turnover tax is the "tax on value added."<sup>21</sup> Simplicity of administration is achieved by having all firms registered file periodic tax returns attested by vouchers showing purchases from other firms.

Taxes on urban land and buildings present special problems of valuation, assessment and collection.<sup>22</sup> Valuation in most countries is sadly out of date and experts should generally be called in to do the job from the ground up.

Market and export taxes are generally regressive and arbitrary. Market taxes are charges placed on persons and

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<sup>21</sup>Ibid., p. 78.

<sup>22</sup>Ibid., pp. 80-83.

goods as they enter a tax jurisdiction. They hinder the movement of persons and goods and they are discriminatory because they are mainly applied to agriculture. National export taxes are the equivalent of locally imposed market taxes and suffer the same defects. The competitive position of the exports a developing country places on the world market are adversely affected by market and export taxes. These should be replaced in the long run with regular income and profits taxes.

Income taxation in developing countries is weak, largely because of the preponderance of agriculture. The individual assessment required in income taxation is difficult to apply to taxpayers who barter their produce for the things they need and are outside an urban unit where net worth would be a meaningful basis of assessment.<sup>23</sup> By beginning income taxation early and at progressive rates the government can get taxpayers accustomed to the idea and as the economy develops, an increasing share of the rising incomes can be secured.

Taxation of mineral companies may be accomplished with royalties and profits taxes. These are important elements of income taxation in such countries as Venezuela and Chile. Taxation of business profits should be done on an equitable basis. High progressive rates should be reserved for personal income taxation otherwise the business

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<sup>23</sup> Ibid., pp. 84-107.

enterprises meant to be encouraged will be discouraged. Risks in manufacturing in a developing country should be recognized.

The income distribution within developing countries has serious implications for income taxation. In the matter of personal exemptions and minimum tax rates the income distribution will give an indication of the tax coverage at given exemption levels and tax rates.<sup>24</sup> Exemptions for a family of four persons in Brazil equal ten times the national per capita income. In Chile and Peru the same family unit receives personal exemptions equal to twenty-five times the annual per capita national income.<sup>25</sup> Effectively large segments of the population have been excused from making any contribution to the support of the nation. Exemption levels and minimum tax rates which are set without reference to a national income distribution may incur either of two undesirable conditions. Levels which are too high may result in coverage so thin that only the very top of the income pyramid is required to file returns and pay taxes. Broad coverage from low levels of exemption may mean that incomes which are at

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<sup>24</sup>Hanson, p. 76.

<sup>25</sup>Richard A. Musgrave, "Estimating The Distribution of The Tax Burden," Problems of Tax Administration in Latin America (Baltimore: The Johns Hopkins University Press, 1965), p. 64.

subsistence levels are reduced to pay taxes. Economic and political unrest could be the legacy of the latter policy.

Taxes on capital gains and capital should be supplementary or complementary to income and profits taxes. Taxes on capital gains are the most important. Speculation in real estate is the most popular outlet for savings in developing countries and capital gains taxation would plug this loophole. The absence of stock exchanges in most countries means there is no problem growing out of securities speculation.

Wealth taxation in developing countries is confined mainly to land. Effective valuation is the requisite to successful taxation of land. Valuation is very difficult when market figures are not available either for land sold or sales figures for the production from the land. Urban land is most susceptible to taxation and the greatest application of wealth taxation will probably fall on it.<sup>26</sup>

Hicks concludes that a number of taxes are appropriate to a program of economic development. However, collections are chronically short of expectation.<sup>27</sup> The greatest reason is that tax administration is inadequate both in number and quality. Hicks recommends steps to improve the picture:

- (1) Increase the number of assessors and collectors,

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<sup>26</sup>Hicks, pp. 104-05.

<sup>27</sup>Ibid., p. 107.

- (a) Special courses in tax techniques,
  - (b) Special courses in economics and finance,
- (2) Unify top level management.

She concludes:

There is no doubt that the additional revenue needed to finance development is largely lying dormant, and if it could be fully collected, it would go far to closing the gap, even at existing tax rates.<sup>28</sup>

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<sup>28</sup>Ibid., p. 107.

## CHAPTER II

### AN INTEGRATED SELF-ENFORCING TAX SYSTEM FOR UNDERDEVELOPED COUNTRIES

Observation of the needs of increased investment for economic development against the performance of existing tax systems in underdeveloped countries caused Professor Higgins to formulate his integrated self-enforcing tax system.

If investment is to be increased and inflation avoided there must be a corresponding increase in revenue. Since developing countries are rarely able to enforce a tax system effectively they especially need one that by its very nature cannot be evaded. There is further need to preserve incentives for private undertakings that contribute to economic growth.

The three general objectives of the Higgins proposal are: (1) to increase revenue, (2) to achieve a high degree of self-enforcement in the tax system, and (3) to preserve private incentives. They are to be achieved by concentrating on lesser but more specific goals.

The specific goals of the Higgins proposal, (1) to increase revenue collected, (2) to increase investment, (3) to

divert investment from low priority to high priority projects, and (4) to control inflation are to be pursued in a free market economy setting. Government will plan the over-all investment program but discretion is to be allowed to private initiative in private projects.

How to increase the revenue is a chronic problem with almost all governments. Dealing with the problem requires consideration of taxable capacity and the structure of taxation. Raising the share of national income taken by taxation by increasing tax rates raises the question how far is it possible to push these rates. A ceiling of 25% of national income has been suggested.<sup>1</sup> However, this limit is based on political rather than economic grounds. The premise is that as the 25% share is reached powerful groups in the economy will force the government to retreat from a policy of increased taxation. On the other hand, where powerful groups support government policy, as in wartime, tax capacity is quite high. If support can be generated for a program of economic development, comparable to the support of a war effort, there is no reason for the limit of taxable capacity to be set at 25% of national income.<sup>2</sup>

There are a number of measures that can be taken to raise the revenue producing ability of a tax system. One

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<sup>1</sup>Higgins, p. 494.

<sup>2</sup>Ibid., pp. 494-97.

measure is to eliminate low yield nuisance taxes which are costly to collect. This increases net yield by lowering the over-all cost of collection. The mixture of direct and indirect taxes which make an effective tax structure may be quite different in an advanced country as opposed to an underdeveloped one. Developed countries tend to rely heavily on direct taxes. The application of direct taxes in underdeveloped countries is limited by the low level of incomes. Supply curves of labor and capital may turn backward at very low income levels. Disincentive effects may occur at extremely low ratios of income tax to income. Developing countries generally rely on indirect taxes (sales, etc.) but have learned to build a high degree of progressivity into them. These types of taxes are more difficult to avoid than direct taxes, particularly incomes taxes, and reliance on them should be continued but in the long run the switch to direct taxes can be made.

Because of the predominance of agriculture in most developing countries, land taxes may be useful. Land taxes based on the output of the land could contribute to equity in the tax structure and improve yields but would have a disincentive effect. A lump sum tax on land would avoid the latter effect.

In many cases a country must rely heavily on import duties and export taxes because of the poverty of the domestic economy. A tax structure which leans on these taxes is unstable because of the vagaries of the world market.

The last consideration of tax structure has to do with the levels of government. Central and local government have different functions in the over-all fiscal picture. "Central fiscal devices . . . are appropriate to levy taxation upon major components of national income which are generated in a particular geographical area or sector of the economy."<sup>3</sup> Local fiscal processes are decentralized in impact and have special advantages in carrying out projects at the local level, administering taxes where discretion is necessary (land valuation), and collecting taxes in kind or forms difficult to measure (labor services).<sup>4</sup>

Increasing the revenue involves securing all revenue legally due through efficient collection and vigorous enforcement of the laws. Vigorous enforcement by the tax authorities is to be backed up by the self-enforcing feature of the tax system in the Higgins proposal. Self-enforcement means that the system is so constructed that an effort to evade one tax automatically involves the taxpayer in other tax liabilities. These other liabilities are so much greater than the beginning liability that evasion is not a paying thing. All taxes in the system are interlocking and all parties to a transaction have adverse interests. Any under-reporting of a transaction would result in a higher tax

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<sup>3</sup>Ibid., p. 512.

<sup>4</sup>Ibid., pp. 509-13.

liability for at least one of the parties so there is a real incentive for honest reporting.

Higgins calls the plan a closed system because of the fact that all taxes in it interlock. The system is derived from a basic structure worked out by Nicholas Kaldor. By adding a penal tax on excess inventories and a turnover tax Higgins achieved a closed system.<sup>5</sup> Safeguards to preserve incentives for private undertakings are built into the system. Private undertakings which contribute to economic growth, Higgins feels, are worthy of special consideration.

Incentives to private undertakings may be utilized in a tax system in several ways:

- (1) Reduction in tax rates. This is a stimulus to spending and if supplies of goods are fixed it would create inflationary pressures.
- (2) Selective tax reduction. There are two common ways to do this. One is to allow the averaging of profits over a period of years. The second is to grant exemption from taxes for a limited period for new investment. However, new investment which made no profit would not be aided by these devices and profit making businesses would not need these incentives.

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<sup>5</sup>Ibid., pp. 525-26.

(3) Increase or reduce tax rates selectively.

This practice takes several forms:

- (a) Accelerated or postponed depreciation is allowed.
- (b) Deductions from taxable income are credited to special reserves for future investment (used in Sweden and Switzerland).
- (c) Limited proportions of profits go untaxed in periods of expansion. Untaxed profits then must be held in the form of non-negotiable no-interest bearing bonds.

(4) Certain taxes are imposed to force people to take action to avoid them. A tax on all assets is an example of this kind of incentive taxation. Rates of tax vary according to the degree of liquidity of the asset held. The highest rates would apply to cash. The taxpayer is diverted from cash balances and savings accounts to productive investment.

(5) Incentive taxes to compel increases in output:

- (a) A standard tax is based on the "normal" output so that increases in output do not increase the tax.
- (b) A lump sum tax is based on "potential" output. This is a tax in inverse ratio

commonly applied to land held in uncultivated status.

1. Authorities estimate the optimum potential production of a given acreage.
2. Less than optimal production is taxed the same as optimal. Greater than optimal production incurs no additional tax.

(6) Taxes linked to government expenditure programs with popular appeal. Programs of road building with the tax paid in personal service in construction work is an example of this type of incentive. Spendings taxes, sales taxes and surmise income taxes are useful where records are absent and there is evidence; e.g., expensive foreign car, palatial residence, or substantial luxury spending. Incentives to save and to invest are important aids in controlling inflation. Controls on consumption as well as checks on hoarding aid in checking inflationary pressures.

Higgins designed his system to be completely closed so that all parties to a transaction can minimize their tax liabilities only by accurate reporting. This feature creates a situation in which all parties to a transaction have

adverse interests which means that each taxpayer has a vital interest in seeing that all those with whom he deals report their transactions with him accurately.

The components of the system are:<sup>6</sup>

- (1) Personal income tax (20% +),
- (2) Corporation income tax (20%),
- (3) General sales or turnover tax (2-7%),
- (4) Tax on all assets:
  - (a) Cash (4-8%),
  - (b) Bonds (3-5%),
  - (c) Equities (2-3%),
  - (d) Productive assets (1-2%)
  - (e) Normal inventories (2%),
- (5) Tax on excess inventories (40%),
  - (a penal tax to discourage hoarding),
- (6) Expenditure tax (6-20%).

#### MECHANISM OF THE SYSTEM

- (1) Sellers report sales to avoid taxes on excess inventory.
  - (a) Profits = gross sales - costs.
  - (b) Excess inventory taxes are always higher than sales taxes plus income taxes on the same volume of goods.

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<sup>6</sup>Ibid., p. 526.

(2) Employers report all salaries and wages to lower their income taxes.

(3) Lower bracket wage and salary earners report sales to them (their expenditures) since the expenditures tax is lower than the assets tax on cash. The computation:

(a) Income - reported expenditures = increase in assets held.

(b) If no purchases of other assets are reported, it is assumed that the difference in income and expenditure is an asset held in cash (imputed increase in cash balances).

(c) Accumulation of cash represents an increase in total net worth, thus a capital gain. Capital gains are a residual:

$$G = \Delta A - I = Y_t - (C + I)$$

C = Consumption  $\Delta A$  = Change in Assets

Held I = Investment  $Y_t$  = Taxable

Income

(4) Buyers report purchases of capital goods as costs to avoid the higher assets tax and a tax on capital gains.

(a) Depreciation allowances are based on purchases of capital goods.

(b) Sellers report sales to avoid excess inventory taxes.

- (5) Taxpayers in high-income low-spending brackets report consumer spending to lower their imputed capital gains thus lowering their taxable income. Consumer spending also lowers their assets tax on imputed increases in cash.<sup>7</sup>

#### EVASION

Successful evasion of all taxes in the system could occur in only two instances:

- (1) Buying goods or assets without reporting or detection and later selling without reporting or detection.
- (2) Reporting false sales (to avoid inventory taxes) and later selling without reporting or detection.

In the first case if the goods are imports, they would have to be smuggled because customs records are easily policed. Large scale domestic producers usually have complete records and they will generally not risk violating income tax laws by not reporting sales. Small domestic producers and wholesalers outside the income tax system are the remaining possibilities as areas of evasion and these could be policed by sample physical checks.

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<sup>7</sup>Ibid., p. 527.

Since most items are too bulky to be hidden in large quantities and storage always involves a document of some kind, warehousemen could be required to report periodically all goods in their care. These reports would be sent to the statistical authorities.

Sellers who desire to have a sale go unreported would have to compensate low-income buyers for the difference between expenditure taxes and the tax on cash assets. High income buyers would demand compensation for the income tax on imputed capital gains plus the tax on cash assets.<sup>8</sup> Capital gains are always a residual. Any income which the taxpayer cannot show as a cash asset or as having been a consumption expenditure is taxed as capital gains. Sample checks on bank statements would tighten all round enforcement.<sup>9</sup>

Speculation in price rises on goods in inventory is a common phenomenon. The inventory tax is designed to control it. Retailers may be tempted to report fictitious sales, pay sales and income taxes on them, then hold the goods without paying the inventory tax and selling later at a higher price without reporting the sales. This involves all the usual problems of tax evasion plus the problem of physically hiding the goods. Payment would be made to informers who aided in recovering the taxes evaded.

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<sup>8</sup>Ibid., p. 527.

<sup>9</sup>Ibid., p. 529.

## ENFORCEMENT

A central role in the scheme is that of the Statistical Office. Each taxpayer would be given a card and code number. Each time he is a party to a transaction, a document is generated which is sent to the Statistical Office where entries are made to his file. Computations of tax liability are made by the Statistical Office. The tax authorities have the task of collecting the tax after the taxpayer's liability is established. An important by-product of the system would be the improvement of economic statistics. National income statistics would be more accurate and more readily available.

The code numbers could be assigned much the same as social security numbers are assigned in the United States. Every person could secure one on simple application. All parties to a property transfer could be required to disclose their numbers. By interlocking taxes on income, capital, and expenditure it becomes vital to the taxpayer's economic interest that all transactions involving him be reported accurately. Underreporting of income would leave a taxpayer with unexplained stocks of capital or expenditures. Underreported expenditures would subject him to higher taxes on increased capital accumulation or force underreporting of income in which case more people would be involved and it becomes less likely that such irregular transactions could be kept secret.

Code numbers would make it easier to check company dividend and share records against reporting of such income by individuals. Purchases of jewelry would become known and it would become possible to check on hoards of jewelry and gold. Paperwork could be held to manageable proportions by exempting small transactions. The Swedish tax system provides a working precedent for the use of code numbers and interlocking taxes.<sup>10</sup>

#### ADVANTAGES OF THE SYSTEM

The advantages claimed for the Higgins proposal are:

- (1) Tax revenue can be increased.
- (2) Investment can be increased.
- (3) Investment can be channeled to desired projects.
- (4) Inflation can be controlled.
- (5) Incentives are preserved for private undertakings of a development nature.
- (6) The system is to a large degree self-enforcing.

The first and second items are closely related and are to be achieved through income taxation to a large extent. A personal income tax at progressive rates, broadly based, is the first step. A flat rate corporation income tax is the second step with broadly based sales and turnover taxes

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<sup>10</sup> Nicholas Kaldor, Indian Tax Reform (New Delhi: Ministry of Finance, 1956), pp. 53-61.

bolstering revenue collections when incomes prove too low to be effectively taxed.

Channeling investment to high priority development projects is the objective of the taxes on all assets with varying rates for each type of asset, depending on the degree of risk and liquidity. Cash holdings (low risk) are taxed at the highest rate while productive assets (higher risk) are subject to the lowest rates. The taxpayer has a real advantage in shifting from a cash position to a productive asset position.

Control of inflation operates through the built-in ability of the progressive income tax to take a larger share of rising incomes coupled with taxes on excess inventories and a tax on expenditures. The tax on excess inventories strikes at the tendencies of businesses to hoard goods in times of rising prices. By forcing these goods onto the market, the price rises can be checked. A tax on all expenditure, at increasing rates, controls the unnecessary spending on luxury goods so characteristic of the wealthy in underdeveloped countries. Necessary consumption expenditure is exempt from the tax as is investment in productive assets.

The preservation of incentives in the private sector is provided for by Higgins. The total tax burden on a given income is minimized by maximizing the share of income spent on productive equipment. Following this is the use

of income in the purchase of equities which helps established firms finance expansion of plant and equipment.

Undisclosed stocks of currency are difficult to control but by treating increases in cash balances as a residual, taxable as income classified as capital gains, the taxpayer is forced to buy securities. This allows him to escape the double taxation of cash balances. Such a device aids in building up a market in government securities and provides a broader base for central bank open market policy.<sup>11</sup>

#### DISADVANTAGES OF THE SYSTEM

The principal disadvantage of the system appears to be the likelihood of increased cost of enforcement both in money terms and manpower commitment. The increased coverage of taxpayers alone will require significant amounts of attention by the tax authorities. A larger tax staff will probably be the result. This means that a larger share of the revenue produced will be needed to defray the cost of its collection.

Higgins recognized this problem and hopes to offset it in two directions, first by increasing revenue collected and second by improving the level of taxpayer compliance by increasing taxpayer contact with the taxing authority. By incorporating as many self-enforcement features as possible

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<sup>11</sup>Higgins, pp. 535-36.

in the system he hoped to hold increased costs of collection and increased size of staff to a minimum.

It has been charged that a system which stresses a strong role in economic development for public investment and taxation of the domestic economy, risks the elimination of all private investment in favor of public investment.<sup>12</sup> Other cases have been made for strong support of public investment because of a lack of private saving and investment at least in the initial stages.<sup>13</sup>

A serious dilemma in the system is a conflict between the self-enforcement goal and the incentive viewpoint regarding reporting of consumer outlays and saving. The tax rate on consumer spending should be lower than the tax rate on imputed increases in cash balances so that it is to the taxpayer's advantage to report his consumption expenditures. On the other hand, incentives will be strengthened if the tax rate on consumer outlay is higher than on any kind of saving. The taxpayer, by saving and investing, can reduce his marginal tax rate below what he would pay on consumer outlays.

#### ANALYSIS OF THE SYSTEM

The Higgins proposal, composed of a mix of several

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<sup>12</sup>Chelliah, p. 56.

<sup>13</sup>Hicks, pp. 47-48.

kinds of taxes, has mixed effects on over-all consumption, saving, investment, and work effort in an economy.

Taxes on consumption are represented in the Higgins plan by the general sales tax and the expenditures tax. A general sales tax is similar to a spendings tax but it appears that Higgins has in mind a general sales tax geared to low rates to regulate mass consumption and a spendings tax at steeply progressive rates to control the lavish outlays of the wealthy and in this context they are different devices.<sup>14</sup>

A general tax on income, where saving is zero, is the same as a general tax on consumption.<sup>15</sup>

Taxation of business profits through a flat rate corporation income tax avoids discrimination against efficiency or bigness per se. It is generally agreed that the place for progression in the tax structure is personal taxation since businesses are owned by individual taxpayers. The only unresolved problem in this area is the taxation of retained earnings. Profits are taxed to the dividend recipients when they are distributed but retained earnings may escape both business taxation and personal taxation if they are never distributed. However, this leads to the argument of accretion versus realization.

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<sup>14</sup> Higgins, p. 553.

<sup>15</sup> Richard A. Musgrave, The Theory of Public Finance (New York: McGraw-Hill Book Company, Inc., 1959), p. 523.

Incentive taxes have the twin functions of encouraging saving and channeling it into the most productive paths of investment. They restrain consumption in some ways but this is the negative side of their natures. It has been observed that the economic surplus (saving) in developing countries needs special attention to be discovered and mobilized. The incentive taxes are designed to aid this discovery and mobilization effort. Special incentives to save may be provided by a spendings tax or a tax on general sales if they are geared to fall on luxury consumption. Higgins relies on both general sales and spendings taxes.

The nature of some incentive taxes is such that they "may be imposed not with the purpose of collecting them, but to persuade people to take certain action to avoid them."<sup>16</sup> Taxes aimed at the hoarding of either goods or money may be in the form of a penal tax on inventories or a tax on the average value of cash balances. The rates of tax on assets diminish with the degree of risk or illiquidity providing a device for controlling choice of investment. For example, cash balances, inventories or unused land would be taxed at a higher rate while government securities and productive assets would be taxed at lower rates or not at all.

An incentive tax which Higgins does not use is the excess capacity tax. Under this tax profits retainable

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<sup>16</sup>Higgins, p. 517.

after taxes vary directly with output and are an incentive to expand production.<sup>17</sup> Under such a tax normal production capacity is established and the utilization of capacity in excess of the normal incurs no additional tax.

The Higgins system seems to offer a mixture of taxes which is balanced to avoid excessive influences in any one direction. In the next section the discussion will focus on a tax system which bears many similarities to the Higgins proposal. The proposals of Kaldor, the source of many of Higgins' ideas, were used to fashion the tax system of India and we now need to look at it as the only existing prototype of the Higgins model.

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<sup>17</sup>Ibid., p. 519.

### CHAPTER III

#### A COMPARISON OF THE HIGGINS PROPOSAL TO THE TAX SYSTEM OF INDIA

Nicholas Kaldor proposed an integrated tax system which included an expenditure tax to the government of India.<sup>1</sup> Many of Kaldor's ideas were incorporated into the tax system of India in 1957-58. Ceylon made use of some of Kaldor's recommendations but repealed its expenditure tax after a brief period. The tax system of India and the Higgins proposal, both lineal descendants of Kaldor's ideas, differ in many respects but their common features provide some interesting comparisons.

#### THE TAX SYSTEM OF INDIA

Taxes in India may be treated under three broad groupings. These are: (1) taxes on income, (2) taxes on capital and (3) taxes on transactions.<sup>2</sup>

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<sup>1</sup>Nicholas Kaldor, Indian Tax Reform (New Delhi: Ministry of Finance, 1956), pp. 39-84.

<sup>2</sup>Harvard Law School, World Tax Series, "Taxation in India" (Boston: Little Brown and Company, 1960), pp. 57-64.

The income tax as applied to individuals consists of income tax and supertax, both of which are levied at graduated rates. Income is conceptually divided into six categories: (1) income from salaries, (2) interest on securities, (3) income from property, (4) profits and gains from a business, profession, or vocation, (5) income from other sources, and (6) capital gains. These groupings are used to apply certain rules and exemptions. All income is lumped and taxed on a global basis. Rates of income tax range from 5% on incomes of Rs. 5,000 or less to 40% on incomes exceeding Rs. 70,000. An additional 65% is charged on the amount by which the income exceeds Rs. 70,000.<sup>3</sup> Corporations are subject to an income tax and supertax but each of these is a flat rate. Corporations are also liable, under certain conditions, for: (1) additional graduated supertax on dividends in excess of prescribed percentages of paid up capital, (2) a special supertax on stock dividends and capitalization of earnings, and (3) a flat rate supertax on undistributed profits.<sup>4</sup>

Taxes on capital include: (1) land revenue, (2) the net wealth tax, (3) the estate tax, and (4) the gift tax.

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<sup>3</sup>Indian Investment Centre, Taxes and Incentives (New Delhi: United India Press, 1968), pp. 20-21.

<sup>4</sup>World Tax Series, India, pp. 75-78.

In most cases land revenue is based on the net produce of agricultural and the reasonable rental value of non-agricultural land. Land revenue is reserved exclusively to the states by the Constitution of India. Few of the states exercise the power to tax land and the income from it. The federal income tax does not apply to agricultural incomes.

The tax on net wealth is based on the total value of all assets minus debts on the date of valuation. "Assets" includes all property of every description, however there are express exclusions from the definition of assets as well as exclusions from taxable wealth. Commonly defined as taxable wealth are: (1) interests in partnerships and associations, and (2) corporate shares. The list of exempt property is very long and includes:<sup>5</sup>

- (1) Co-parcenary property of a Hindu undivided family,
- (2) An interest in property extending less than six years,
- (3) Land, buildings, and other assets used in agriculture,
- (4) Professional equipment to a maximum of Rs. 20,000 in value.

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<sup>5</sup> Ibid., pp. 405-15.

- (5) Investment in new and separate units of industrial corporations is, under certain conditions, exempt for five tax years,
- (6) Shares of one corporation owned by another corporation,
- (7) Certain government securities,
- (8) Assets used in scientific research,
- (9) Patents and copyrights,
- (10) Annuities, pensions, provident funds and insurance policies,
- (11) Property held in trust for charitable or religious purposes,
- (12) Miscellaneous personal assets:
  - (a) Jewelry to a maximum value of Rs. 25,000,
  - (b) Works of art,
  - (c) Heirlooms,
  - (d) Furniture and other personal and household goods,
  - (e) A single rural residence,
  - (f) Property received as a meritorious award,
  - (g) Animals.

Certain of the exemptions are meant to be tax incentives for economic development. Items (5) and (6) are examples.

Rates of wealth tax are graduated from 1% to 2.5% for individuals with net wealth exceeding Rs. 200,000.<sup>6</sup> Corporations with net wealth in excess of Rs. 500,000 are taxed a flat 0.5% on the excess.

There are several allowances and adjustments against the wealth tax. The two most important ones are to shareholders in corporations and to loss corporations. The adjustment allowed to shareholders is designed to mitigate the effects of double taxation of corporate shares.<sup>7</sup> Corporations which show an operating loss in the year are allowed a reduction of wealth tax which may result in zero tax.

The estate tax is levied on "all property, interests, and powers held at death." Rates of tax begin at 4% on estates with an aggregate value in excess of Rs. 50,000. Values in excess of Rs. 2,000,000 are taxed at a rate of 40% plus an additional 85% of the excess over Rs. 2,000,000.<sup>8</sup> There are two kinds of exemption in computing the estate tax. First, there are certain classes of property which are not included in the estate for purposes of the tax. These include: (1) real property located outside India, (2) household goods, (3) works of art, (4) all property of a member

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<sup>6</sup>Indian Investment Centre, p. 56.

<sup>7</sup>World Tax Series, India, p. 417.

<sup>8</sup>Indian Investment Centre, pp. 60-61.

of the armed forces who is killed in action, and (5) the official residence of a ruler of a former Indian state. Second, certain property is included in the estate but is exempt from tax. This includes: (1) gifts (to a maximum of Rs. 2,500) made by a decedent for public charitable purposes within six months of date of death, (2) money deposited with the government for purposes of paying estate tax is exempt to the extent of the tax payable, and (3) agricultural land, with certain qualifications, located in India.<sup>9</sup>

A gift tax is levied on taxable gifts, valued at more than Rs. 15,000, at rates graduated from 5% to 40%.<sup>10</sup> The 40% rate attaches to gifts in excess of Rs. 1,490,000. An additional 50% of the excess of Rs. 1,490,000 is charged. A gift is defined as, "Any voluntary transfer of existing property for less than full consideration in money or monies worth."<sup>11</sup> Transfers which are subject to the estate tax, as gifts in contemplation of death, are exempt from gift tax.

Taxes on transactions are the most diverse group of Indian taxes. This group is composed of sales, excise, customs duties, and the expenditure tax.

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<sup>9</sup>World Tax Series, India, pp. 102-03.

<sup>10</sup>Indian Investment Centre, pp. 57-59.

<sup>11</sup>World Tax Series, India, p. 113.

Sales taxes are levied both by the central government of India and the several state governments. The Constitution provides that the states have exclusive power to tax intra-state sales and purchases while the central government has the exclusive power to tax transactions in interstate trade. The sales taxes are collected by the central government but are distributed to the states in which they are collected.<sup>12</sup>

The state sales taxes usually apply to tangible movable property and provision is made for certain classes of exemption. These are:

- (1) Necessaries or essential goods (food, medicine, matches, inexpensive textiles, certain raw materials),
- (2) Goods subject to high taxes under other laws of the state or central government (fuel oil, electricity, tobacco),
- (3) Goods produced by small scale (cottage or village) industries (handmade textile fabrics, paper).

Rates of tax range from under 1% to more than 14% among the states.<sup>13</sup> The sales tax imposed by the central government has specific exclusion for stocks, shares, securities, and actionable claims. The average rate of tax is 7% of sales

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<sup>12</sup> Ibid., p. 119.

<sup>13</sup> Ibid., p. 445.

price. The central government imposes certain restrictions on state taxation of special categories of raw materials and the taxation of sales of newspapers is prohibited to both central and state governments by the Constitution.

Stamp duties are imposed concurrently by the central and state governments. The central government has exclusive power in the matter of rates on bills of exchange, checks, promissory notes, bills of lading, letters of credit, insurance policies, transfers of shares, debentures, proxies, and receipts. The states have the power to set rates on other non-judicial documents. Both state and central governments are forbidden by the Constitution to tax judicial documents.<sup>14</sup> The central government stamp tax is collected and retained by the states.

Excise taxes are reserved to the central government by constitutional provision. This provision allocates power to levy excises on alcoholic liquors and narcotics, not used for medicinal or toilet preparations, to the states. Central government levies on alcohol and narcotics are collected and retained by the states. All other excises are levied by the central government. Some goods (such as tobacco and coffee) are taxed at specific flat rates while others (tires, woolen fabrics, footwear and electric batteries) are levied at ad valorem rates. A 25% share of the proceeds of the taxes collected is distributed among the states.

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<sup>14</sup> Ibid., pp. 119-27.

A variety of special excises are levied on certain designated goods to offset the cost of programs undertaken by the government to benefit particular industries.

Excise taxes are levied on the manufacturer, wholesaler, curer or other person who completes the process of manufacture so that the goods are ready for final sale.<sup>15</sup>

A range of rates is applied to the various commodities that are subject to excises. Some of these are: mechanical lighters, 75% ad valorem, motor vehicle tires, 40% ad valorem, footwear, 10% ad valorem, and electric batteries, 10% ad valorem.<sup>16</sup>

All customs duties, both import and export, are levied by the central government because of the allocation of tax powers under the Constitution. Commodities on the import duty list are classified as "protective," "revenue," or "preferential revenue." Most tariff rates are ad valorem. Rates are generally 30% to 40%. Luxury goods or competitors of plentiful domestic goods are subject to much higher rates. For example, such products as wines and spirits, silk garments, spices and motor vehicles are subject to rates of from 75% to 200%. The many tariff rates and exemptions are published in the Gazette of India.<sup>17</sup>

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<sup>15</sup> Ibid., p. 455.

<sup>16</sup> Ibid., pp. 459-60.

<sup>17</sup> Ibid., p. 129.

The expenditures tax, one of the unique recommendations made by Kaldor, was first levied in India in 1958.

Kaldor recommended an expenditures tax on three grounds:<sup>18</sup>

(1) it provides a better measure of taxable capacity than an income tax, (2) it provides more incentive for saving than an income tax, and (3) as part of an integrated system it could contribute to a more effective administration of all direct taxes.

Persons subject to the expenditure tax include individuals and Hindu undivided families. Corporations, trusts and decedents' estates, partnerships, associations and local authorities are not subject to the tax. Special treatment is accorded former rulers of Indian states but they are not exempt. The maintenance of his official residence and compensation of staff, paid out of his privy purse, is exempt from the expenditure tax. The tax base is "expenditure incurred" and includes amounts actually spent and amounts for which a liability has been incurred. Both amounts paid and amounts accrued constitute expenditure for tax purposes.

Individuals are entitled to a single standard allowance of Rs. 30,000 for living expenses as an exemption from the expenditure tax. A maximum standard allowance of Rs. 60,000 is allowed Hindu undivided families. Rates of tax begin at 10% on taxable expenditure of Rs. 10,000 or less. Thereafter

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<sup>18</sup> Ibid., p. 422.

rates are steeply progressive until a rate of 100% is reached on taxable expenditure in excess of Rs. 50,000.<sup>19</sup>

Provision is made for the spreading of certain expenditure over a five-year period for tax purposes. In the base year 20% of the expenditure would be included in the tax base and 20% each year for four succeeding years. This privilege is extended to articles for personal use including: purchase of bullion, precious stones, jewelry, furniture, and other household goods, as well as automobiles and other conveyances.

All expenditure incurred in earning income is exempt. All business-related capital expenditure is exempt as well as a host of non-business investment expenditures. The latter include:<sup>20</sup>

- (1) Expenditure in deposits, loans, shares, and securities,
- (2) Contributions as capital to a firm or association in consideration of a share of profits,
- (3) Repayment of loans or borrowings,
- (4) Certain interest payments,
- (5) Expenditure for the acquisition of immovable property,

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<sup>19</sup> Ibid., p. 433.

<sup>20</sup> Ibid., p. 428.

- (6) Contributions to a provident, thrift, or pension fund.
- (7) Certain types of insurance premiums:
  - (a) Insurance on the life of the taxpayer or his dependants.
  - (b) Insurance for the education or marriage of any of the taxpayer's dependants.
  - (c) Health, accident or disability insurance on the taxpayer.
  - (d) Fire or theft insurance on any property other than aircraft, motor vehicles, or other transport vehicles.

The following expenditures, regardless of purpose, are exempt from expenditure tax:

- (1) Purchase of books,
- (2) Purchases of works of art or products of cottage industry in India, whose price exceeds Rs. 1,000,
- (3) Expenditure for the purchase and maintenance of livestock.

Many other personal and family expenditures are exempt. Some of these are:

- (1) Expenses of seeking elective office in India,
- (2) Expenses incurred in certain civil or criminal proceedings,

- (3) Expenditures for the marriage of a taxpayer or dependent. This extends to Hindu undivided families,
- (4) Expenses for the maintenance of the taxpayer's parents, not to exceed Rs. 4,000 per year,
- (5) Expenses for the medical treatment of the taxpayer, his dependents or parents,
- (6) Expenditure for education outside India for the taxpayer or his dependents.

Neither agricultural land nor agricultural income is subject to tax by the central government by constitutional prohibition but expenditure from agricultural income is not exempt from the expenditure tax.<sup>21</sup>

The data (Table I) show that total tax revenue was increased from 575.33 (Crores of Rupees) in the period 1957-58 to 1,562.80 (Crores of Rupees) in 1964-65 with a projected budget of 1,942.53 (Crores of Rupees) in 1966-67. This represents an increase of three and one-half times over an eight-year period. Revenue in each of the three categories showed remarkable growth as well.

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<sup>21</sup>Ibid., p. 427.

<u>Classes of Tax</u>	<u>Beginning Period</u> <u>1957-58</u>	<u>Ending Period</u> <u>1965-66</u>
Income & Expenditure	146.40	467.41
Property & Capital Transactions	10.61	22.67
Commodities & Services	418.32	1,265.93

Amounts are Crores of Rupees.

After adjustments for inflation the increase in revenue is sizable and indicates that the tax structure has been effective in raising revenue. It gives no real indication as to the revenue which might have been raised by an alternative structure but it seems likely that the present structure has not materially retarded collections.

TABLE I

## SOURCES OF CENTRAL GOVERNMENT TAX REVENUE

		1957-58
I.	Taxes on Incomes and Expenditures <u>Total</u>	146.40
	Taxes on Income other than Corporation Tax	163.70
	Less State Share	73.43
	1. Net Receipts	90.27
	2. Corporation Tax	56.13
	3. Expenditure Tax	- -
II.	Taxes on Capital and Capital Transactions <u>Total</u>	10.61
	Estate Duty	2.31
	Less State Share	2.40
	1. Net Receipts	-0.09
	2. Wealth Tax	7.04
	3. Gift Tax	- -
	4. Stamps and Registration	3.31
	5. Land Revenue	0.35
III.	Taxes on Commodities and Services <u>Total</u>	418.32
	Customs:	
	Imports	150.94
	Exports	26.83
	Other Revenue	7.28
	1. Net Receipts	179.99
	Union Excise Duties	273.62
	Less State Share	40.22
	2. Net Receipts	233.40
	3. Other Taxes and Duties	5.66
IV.	Total Tax Revenue (Sum of I, II, and III) <u>Total</u>	575.33

Amounts are in Crores of Rupees: Rs. 10,000,000 = 1 Crore

Source: Reserve Bank of India, "Government of India Budget 1966-67," Bulletin of the Reserve Bank of India (Bombay, India, March, 1966), pp. 221-22.

TABLE I (Continued)

<u>1958-59</u>	<u>1959-60</u>	<u>1960-61</u>	<u>1961-62</u>	<u>1962-63</u>	<u>1963-64</u>
151.18	176.88	191.97	228.84	312.39	414.02
172.01	148.85	167.38	165.39	185.96	258.60
75.80	79.32	87.37	93.85	95.27	119.29
96.21	69.53	80.01	71.54	90.69	139.31
54.33	106.56	111.05	156.46	221.50	274.59
0.64	0.79	0.91	0.84	0.20	0.12
14.91	17.02	13.49	14.21	16.15	17.02
2.70	2.91	3.09	4.21	3.94	4.67
2.38	2.76	2.91	3.88	3.88	4.22
0.32	0.15	0.18	0.33	0.06	0.45
9.67	12.11	8.15	8.26	9.54	10.20
0.98	0.81	0.89	1.01	0.97	1.12
3.41	3.35	3.68	4.05	5.00	4.94
0.53	0.60	0.59	0.56	0.58	0.31
386.97	448.54	524.68	632.32	732.44	943.29
116.53	135.82	154.61	198.22	238.42	334.25
20.34	14.89	13.12	12.69	9.60	3.37
5.41	9.56	8.21	7.82	7.50	8.01
138.29	186.11	170.93	212.25	245.96	334.74
312.94	360.65	416.35	489.31	598.83	729.58
72.99	74.70	75.10	80.65	124.91	135.99
239.95	285.95	341.25	408.66	473.92	593.59
7.38	6.74	11.30	11.41	12.56	14.96
553.06	642.44	730.14	875.37	1,060.98	1,374.33
<u>Actual</u>					

TABLE I (Continued)

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<u>1964-65</u>	<u>1965-66</u>	<u>1966-67</u>
457.27	467.41	540.22
266.55	260.00	294.45
123.77	123.34	130.45
142.78	136.66	164.00
314.05	330.00	376.07
0.44	0.75	0.15
17.49	22.67	21.17
5.43	7.00	8.10
6.78	6.79	7.80
-1.35	0.21	0.30
10.50	14.00	14.00
2.22	3.00	1.29
4.97	5.26	5.38
0.15	0.20	0.20
1,089.04	1,265.93	1,381.14
404.64	538.79	567.40
2.42	2.05	2.07
4.22	4.16	3.33
397.50	531.20	560.52
801.51	861.35	1,022.04
127.34	145.92	222.84
674.17	715.43	799.22
17.37	19.30	21.40
1,562.99	1,756.01	1,942.53
- - - -	Revised Count	Budget Estimate

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The tax structure was subject to many alterations between 1957 and 1964 and the need for stability of tax rates and over-all policy became evident. Stability was given consideration in the central government budget for 1965-66.<sup>22</sup>

The budget has further sought to achieve a measure of stability in taxation policies in order that the tax structure of the country may be placed on a more enduring and rational basis.

Further:

As regards personal taxation, simplification of the whole tax structure is sought to be achieved by integrating super tax with income tax and replacing the present taxes by a revised and unified schedule aimed at lowering taxes at all levels of personal incomes so as to stimulate a greater flow of personal savings and at the same time to reduce the scope and incentive for tax evasion.

If the adjustments proposed in the 1965-66 budget succeed in reducing the incentive to evasion of the personal income tax and broaden its coverage it will be a significant achievement. The total number of assesseees for personal income tax in 1957-58 was only 570,172. In 1963-64 the number of personal income taxpayers was only 1,036,533 out of a population of about 550 million (Tables II, III, IV, & V.)

The backbone of the revenue system of India is the taxation of commodities and services. This group composes more than 70% (1,265.93) of the 1,756.01 (Crores of Rupees) in the 1965-66 budget. This seems to support Higgins' contention that developing countries should continue to rely

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<sup>22</sup> Bulletin of the Reserve Bank of India, "Government of India Budget 1965-66," March, 1965, pp. 267-68.

on indirect taxation instead of trying to make an immediate switch to direct taxation of income. The state governments derive their largest slice of revenue from the general sales tax (Table X). Agricultural incomes, solely the province of state taxation, contribute a negligible amount to the state treasuries.

TABLE II  
INCOME TAX ASSESSMENTS BY CLASSES OF TAXPAYERS

Class of Taxpayer	Number of Taxpayers		Income Assessed		Tax Assessed	
	1957-58	1963-64	1957-58	1963-64	1957-58	1963-64
Individuals	570,172	1,036,533	605.00	959.10	90.33	115.80
Hindu Undivided Families	54,608	71,536	77.20	89.70	12.33	12.80
Unregistered Firms and Other Associations	28,279	25,877	34.46	34.90	6.75	7.60
Registered Firms	9,330	33,741	74.17	205.00	2.24	9.30
Companies	10,989	10,316	219.69	271.50	110.50	136.20
<u>Totals</u>	673,378	1,144,262	1,010.52	1,560.30	222.16	281.80

Figures are in Crores of Rupees: Rs. 10,000,000 = 1 Crore.

Source: Government of India, Central Board of Direct Taxes, All India Income Tax Statistics for the Year 1963-64, p. ix.  
Bulletin of the Reserve Bank of India, June, 1959, Income Tax Revenue Statistics, Statements 3 and 5, p. 719.

TABLE III  
INCOME TAX ASSESSMENTS BY RANGE OF INCOME  
FOR THE YEAR 1963-64

<u>Range of Income</u>	<u>Number of Assesseees</u>	<u>Income Assessed</u>	<u>Tax Assessed</u>
Below Rs. 10,000	859,098	483.8	11.3
10,001      20,000	195,846	268.6	20.3
20,001      50,000	93,995	286.3	46.0
50,001      100,000	20,644	139.2	34.4
100,001      500,000	7,337	133.1	47.8
Above 5 lakhs	1,103	249.3	122.0
<u>Totals</u>	1,178,024	1,560.3	281.8

Amounts are in Crores of Rupees: 1 Crore = Rs. 10,000,000.

1 lakh = Rs. 100,000.

Source: Government of India, Central Board of Direct Taxes, All India Income Tax Statistics for the Year 1963-64, p. viii.

TABLE IV  
ASSESSMENTS OF INDIVIDUALS BY SOURCES OF INCOME

	<u>Number of Taxpayers</u>		<u>Income Assessed</u>		<u>Tax Assessed</u>	
	<u>1957-58</u>	<u>1963-64</u>	<u>1957-58</u>	<u>1963-64</u>	<u>1957-58</u>	<u>1963-64</u>
Salary Earners	256,271	518,539	256.83	474.53	33.83	40.73
Non-salary Earners	313,901	517,995	347.99	532.98	56.49	75.10
<u>Totals</u>	<u>570,172</u>	<u>1,036,533</u>	<u>605.02</u>	<u>1,007.53</u>	<u>90.32</u>	<u>115.83</u>

Amounts are in Crores of Rupees.

Rs. 10,000,000 = 1 Crore.

1 Crore = Rs. 10,000,000.

1 Abja = 100 Crore.

1 Lakh = Ps. 100,000.

Source: Government of India, Central Board of Direct Taxes, All India Income Tax Statistics for the Year 1963-64, pp. 60-61.  
Bulletin of the Reserve Bank of India, June, 1959, p. 719.

TABLE V

## DISTRIBUTION OF INCOME AND TAX ASSESSED BY SOURCE OF INCOME

<u>Source of Income</u>	<u>Per Cent of Income Assessed</u>		<u>Per Cent of Total Tax</u>	
	<u>1957-58</u>	<u>1963-64</u>	<u>1957-58</u>	<u>1963-64</u>
Salaries	22.00	23.96	10.02	10.79
Interest on Securities	1.36	0.43	2.36	.77
Property	3.43	2.69	2.65	2.41
Shares & Partnerships		11.97		13.03
Business & Professions	56.92	52.13	63.46	58.32
Dividends	5.39	3.93	9.50	7.50
Capital Gains	0.09	0.36	0.08	0.44
Other Sources	10.89	4.17	11.66	6.16
<u>Total</u>	100.00	100.00	100.00	100.00

Total Income Assessed: 1957-58 = Rs. 1,010.52 Crores = 100.00.  
 1963-64 = Rs. 1,574.60 Crores = 100.00.

Total Tax: 1957-58 = Rs. 222.16 Crores = 100.00.  
 1963-64 = Rs. 298.50 Crores = 100.00.

Source: Government of India, Central Board of Direct Taxes, All India Income Tax Statistics for the Year 1963-64, p. ix.  
 Bulletin of the Reserve Bank of India, June, 1959, p. 719.

Income taxation in India, particularly company profits is very severe.<sup>23</sup> Despite concessions to new investment for exemption from income tax for a period of years and development rebates the taxation of income is progressive and the rates are relatively high. If the coverage of the tax could be extended to small shopkeepers and traders the revenue could be increased. Because of the lack of records of these two groups the use of a schedular income tax system, a tax based on a percentage of turnover, has been suggested.<sup>24</sup> Another possibility for increasing coverage is for the states to delegate their power to tax agricultural incomes to the central government.<sup>25</sup> The central government income tax could then apply to all income regardless of source.

How have savings and investment fared in an economy in which tax revenue was raised so dramatically over such a short period? It is estimated that saving increased from 393.3 (crores of Rupees) in 1952-53 to 1,300.7 in 1962-63 and that over the same period investment increased from 376.9 to 1,694.4 (Tables VI and VII). In 1952-53 investment as a percentage of National Income was 4% and in 1962-63 it had increased to 12.7% (Tables VIII and IX).

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<sup>23</sup> Chelliah, p. 116.

<sup>24</sup> Ibid., pp. 120-21.

<sup>25</sup> Ibid., pp. 121-122.

Data showing the volume and pattern of saving show that saving as a per cent of National Income was 5.0% for the period 1950-53 and 9.3% for 1959-63. The figures in 1948-49 prices, were 459.9 (Crores of Rupees) and 1,189.3, respectively. Of the total saving in the latter period, 22.5% was in the government sector, 6.8% was in the domestic corporate sector, and 70.7% was in the household sector. Within the household sector 76.7% of household savings went to urban households. Urban households had 54.2% of total saving in the economy. The household saving represented 6.6% of National Income.

Saving in the household sector was 840.5 (Crores of Rupees) in 1959-63 of which 399.0 was held as financial assets and 441.5 was held as physical assets. An increase in corporation and cooperative shares is noticeable. In 1950-53 these were 21.3 but holdings were up to 56.6 in 1959-63.

It is by no means certain that the alterations in the tax structure which were instituted at the urging of Kaldor are entitled to full credit for the performances noted. These reforms, particularly the expenditure tax, became effective in March 1958 when the economy was already experiencing difficulty. Total tax revenue dropped in 1958-59 to 553.06 (Crores of Rupees) from 575.33 in 1957-58 but recovered in 1959-60 and reached 642.44. Aggregate investment dropped in 1957-58 to 1,286.9 from a 1956-57 high of 1,454.3 which was not equalled or

surpassed until 1960-61. Saving dipped significantly in 1957-58. Investment as a percent of National Income reached a peak of 12.9% in 1956-57 and tapered off in both 1957-58 and 1958-59. Previously, it had registered a steady rise from 1951-52 through 1956-57.

TABLE VI

## VOLUME AND PATTERN OF SAVING IN INDIA, 1950 to 1963

	Period				1st Plan	2nd Plan
	I	II	III	IV		
1. Government Sector	119.4	101.8	149.8	267.3	114.9	170.1
a. % of Total Saving	26.0	12.8	16.8	22.5	17.6	17.3
b. % of National Income	1.3	1.0	1.3	2.1	1.2	1.5
2. Domestic Corporate Sector	30.5	47.2	34.6	81.5	40.2	50.6
a. % of Total Saving	6.6	6.0	3.9	6.8	6.2	5.1
b. % of National Income	0.3	0.5	0.3	0.6	0.4	0.4
3. Household Sector	310.0	643.5	705.9	840.5	495.7	762.4
a. % of Total Saving	67.4	81.2	79.3	70.7	76.2	77.6
b. % of National Income	3.4	6.2	6.3	6.6	5.0	6.6
Rural Households	151.7	170.4	179.3	196.5	163.7	185.2
Urban Households	158.3	473.1	526.6	644.0	332.0	577.2
4. Total Saving	459.9	792.5	890.3	1,189.3	650.8	983.1
b. % of National Income	5.0	7.7	7.9	9.3	6.6	8.5

Annual average of 1948-49 prices      Periods: I = 1950-51 to 1952-53    II = 1953-54  
 Figures are in Rs. Abja. Abja = 100 Crores      to 1955-56    III = 1956-57 to 1958-59  
    IV = 1959-60 to 1962-63  
    1st Plan = 1951-52 to 1955-56  
    2nd Plan = 1956-57 to 1960-61

Source: Bulletin of the Reserve Bank of India, April, 1962, pp. 330-32.

TABLE VII

	Period				1st Plan	2nd Plan
	I	II	III	IV		
A. Financial Assets	13.0	271.3	312.1	399.0	167.0	336.9
% of National Income	0.2	2.7	2.8	3.1	1.7	2.9
1. Currency	-17.4	104.9	65.9	124.5	37.7	92.2
2. Net Bank Deposits	-16.3	8.9	27.9	48.2	2.5	27.2
3. Insurance Policies	14.6	24.7	25.6	49.5	20.3	32.4
4. Provident Funds	34.0	86.2	96.0	129.1	66.2	105.3
5. Net Claims on Govt.	-23.2	77.3	40.1	-8.9	10.0	25.5
6. Corporate & Cooperative Shares & Securities	21.3	39.3	56.6	56.6	30.3	54.3
B. Physical Assets	297.0	372.2	393.8	441.5	328.7	425.5
% of National Income	3.2	3.5	3.5	3.5	3.3	3.7
C. Total Household Saving (A + B)	310.0	643.5	705.9	840.5	495.7	762.4
% of National Income	3.4	6.2	6.3	6.6	5.0	6.6

Annual avg. of 1948-49 prices      Periods: I = 1950-51 to 1952-53    II = 1953-54 to 1955-56  
Amts. are Rs. Abja. Abja = 100 Crores.      III = 1956-57 to 1958-59    IV = 1959-60 to 1962-63  
Rs. 10,000,000 = 1 Crore      1st Plan = 1951-52 to 1955-56    2nd Plan = 1956-57  
to 1960-61

Source: Bulletin of the Reserve Bank of India, April, 1962, pp. 330-32.

TABLE VIII

## ESTIMATES OF AGGREGATE INVESTMENT AND NET NATIONAL OUTPUT (1965-66 PRICES)

	Saving	Net Capital - Inflow	Investment	Net National Output	Investment as a % of National Income
1950-51	Rs. 541.9	-7.9	Rs. 534.0	Rs. 953.0	5.6
1951-52	529.4	+224.4	753.8	997.0	7.6
1952-53	408.3	-17.0	391.3	982.0	4.0
1953-54	565.0	-3.5	561.5	1,048.0	5.4
1954-55	764.2	+46.5	810.7	961.0	8.4
1955-56	970.5	+63.5	1,033.7	998.0	10.4
1956-57	1,076.4	+377.9	1,454.3	1,131.0	12.9
1957-58	797.8	+489.1	1,286.9	1,139.0	11.3
1958-59	931.4	+399.3	1,330.7	1,260.0	10.6
1959-60	1,102.0	+258.3	1,360.3	1,295.0	10.5
1960-61	1,371.9	+497.0	1,869.2	1,414.0	13.2
1961-62	1,373.8	+381.3	1,755.1	1,480.0	11.9
1962-63	1,498.4	+453.5	1,951.9	1,540.0	12.7
1963-64	-	-	-	1,721.0	-
1964-65	-	-	-	2,001.0	-

Figures represent Crores of Rupees.

Small discrepancies in figures result from rounding of totals.

Source: Bulletin of the Reserve Bank of India, March, 1965, p. 331.  
Bulletin of the Reserve Bank of India, April, 1966, pp. 395-96.

## TABLE IX

## PART I

## SOURCES OF NATIONAL INCOME (1948-49 PRICES)

	1950-51	1960-61	1964-65
Agriculture	Rs. 43.4	59.0	65.0
Mining	14.8	21.1	25.5
Commerce	16.6	24.6	29.7
Services	13.9	23.1	31.4
Net Domestic	88.7	127.8	151.6
Amounts represent Rs. Abja. Abja = 100 Crores.			

## PART II

## INVESTMENT, INVESTMENT-INCOME RATIOS,

## AND CAPITAL-OUTPUT RATIOS

(1948-49 PRICES)

	Investment (annual avg.) (Crores)	Investment/ Income Ratio (per cent)	Capital/ Output Ratio
Period I	Rs. 520.3	5.7	- -
Period II	830.1	8.1	2.22:1
Period III	1,291.8	11.5	4.21:1
Period IV	1,542.9	12.1	3.91:1

Source: Bulletin of the Reserve Bank of India, April, 1966, pp. 395-96.  
 Bulletin of the Reserve Bank of India, March, 1965, p. 331.

TABLE X  
SOURCES OF STATE GOVERNMENT TAX REVENUES  
(EXCLUDING JAMMU AND KASHMIR)

	1957-58	1958-59	1964-65	1965-66	1966-67
Total Tax Revenue Rs. = Crores	449.07	476.68	764.00	809.00	918.00
Land Revenue	87.69	95.09	120.00	104.00	120.00
State Excise	43.20	42.56	85.00	91.00	99.00
General Sales	97.26	75.38	295.00	323.00	371.00
Motor Vehicles Tax	18.95	19.60	59.00	64.00	70.00
Entertainment	8.02	8.38	25.00	27.00	30.00
Electricity	6.43	7.53	33.00	35.00	44.00
Stamps & Registration	30.62	31.45	69.00	72.00	74.00
Agricultural Income Tax	6.77	8.05	11.00	11.00	11.00
Tax on Motor Spirit	10.03	11.32	23.00	31.00	37.00
Other	20.48	19.87	44.00	51.00	62.00

State share of Central Govt. Revenues not shown in detail but included in totals.

Source: Selected years taken from "Finances of State Governments, 1966-67," Bulletin of the Reserve Bank of India, May, 1966, pp. 461-507.

How much of the gains since the low points noted are due to reforms in the tax structure and how much is due to the normal recovery from financial distress and collapse of the balance of payments is an open question. The tax reforms occurred near the low points of the declines in saving, investment and revenue collected but the many extraneous factors involved do not permit a blanket statement that recovery was achieved through tax reform. The effects of short periods of armed conflict with both China and Pakistan during the period make analysis difficult.

Ceylon poses an interesting contrast to India for the period 1950-66. While India was making great gains in revenue collected, household savings achieved, and investment the experience of Ceylon was one of failure. The failure has been attributed to several factors:<sup>26</sup>

- (1) High consumption and import propensities  
in the private sector,
- (2) Sluggishness of public revenues,
- (3) Shortcomings of public investment allocation,
- (4) Failure to stimulate an adequate volume of  
private investment.

Uncontrolled consumption patterns brought about by boom conditions in the mid-1950's resulted in pressure on the balance

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<sup>26</sup> D. R. Snodgrass, Ceylon (Homewood, Ill.: Richard D. Irwin Press, Inc., 1966), p. 214.

of payments. No vigorous concerted effort was made to collect the public revenue or to overhaul the antique tax system until late in the period. Public investment of a productive nature was accorded low priority and was shelved in the face of demands for heavy consumption and transfer expenditures. Private saving was scarcely 4.5% of national income in 1960, a decline of almost half since 1950, which accounts for the lack of private investment (Table XI).

It may be said that, " . . . failure to provide internal finance for an adequate volume of investment was undoubtedly the most important shortcoming of Ceylon's transitional economy."<sup>27</sup>

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<sup>27</sup> Ibid., p. 182.

TABLE XI  
REVENUE AND EXPENDITURES OF THE GOVERNMENT OF CEYLON

	<u>Total Revenue</u>	<u>Goods &amp; Services</u>	<u>Transfers &amp; Subsidies</u>	<u>Fixed Investment</u>
1950	658.9	342.2	172.1	222.4
1951	819.4	399.5	287.4	241.3
1952	842.0	440.6	365.2	308.3
1953	856.5	470.0	260.0	292.9
1954	926.4	483.8	177.5	264.2
1955	1,029.4	530.6	231.5	315.3
1956	1,112.3	568.1	318.2	335.1
1957	1,124.1	638.4	373.0	328.2
1958	1,150.0	745.6	430.5	345.4
1959	1,191.7	831.5	477.2	355.2
1960	1,363.3	873.8	526.4	378.7

Figures represent millions of Rupees.

Grants from foreign governments, a means of financing deficits, are not shown.

Source: Donald R. Snodgrass, Ceylon: An Export Economy in Transition (Homewood, Illinois: Richard D. Irwin, Inc., 1966), p. 195.

## THE HIGGINS PROPOSAL AND THE EXPERIENCE OF INDIA

### Capital Formation

The data show that tax revenue, saving and investment were increased in India while a tax structure was in effect that in a number of ways resembles the Higgins Integrated Self-Enforcing Tax System. Some of the common features are:

- (1) A progressive personal income tax,
- (2) A flat rate corporation income tax,

(3) Broadly based indirect taxation,

(4) Taxes on wealth,

(5) An expenditure tax.

The excess inventory tax that Higgins recommends as a good tool for fighting inflation by forcing hoards onto the market is missing. In the area of broadly based indirect taxation Higgins proposed a 2% sales or turnover tax and India uses variable rate taxation of a long list of commodities and services.

Investment as a per cent of National Income was almost 13% in 1962-63 which shows that a respectable amount of capital was being formed. However, a comparable percentage was achieved in 1956-57 but slipped over the intervening period until a high of 13.2% was registered in 1960-61. It appears that a high rate of capital formation is not incompatible with a comprehensive tax system.

Of the saving which took place in the Plan IV period (1959-63) 22.5% was achieved in the government sector. This saving, 267.3 (Crores of Rupees), in the government sector was 2.1% of the National Income and represents a marked increase in the share of National Income devoted to saving over previous periods. Household savers achieved the greatest growth in savings in the period. They had 70.7% of all saving in Period IV which equalled 6.6% of the National Income. If household savings represent a large share of gross domestic capital formation incomes

are normally growing.<sup>28</sup> Average per capita income in India for 1961 was \$69.<sup>29</sup> This low figure did not prevent the economy from approaching a percentage of National Income saved of 12 per cent. W. A. Lewis regards 12% as an achievable figure for the most poverty stricken developing country and says that the "state capitalists" of India because of their "determination to create capital rapidly on public account" should be able to raise saving and productive investment to desired levels.<sup>30</sup> Investment as a per cent of National Income was 12.7 per cent in 1962-63.

In its role as investor, government may finance capital formation with:<sup>31</sup>

- (1) Internal savings. This represents the difference between taxes and operating expenditures of the government.
- (2) External savings. These savings are acquired from households and businesses. This may represent an expansion of holdings of government debt by households and businesses. Bank

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<sup>28</sup> Kindleberger, p. 99.

<sup>29</sup> Ibid., p. 13.

<sup>30</sup> W. A. Lewis, The Theory of Economic Growth (Homewood, Ill.: Richard D. Irwin, Inc., 1955), pp. 236-38.

<sup>31</sup> Kindleberger, p. 101.

Bank notes are the most common form of government debt. A deficit financed by inflation results in reduced consumption caused by rising prices.

Regardless of the form of its investment the government of India has raised the government share of saving significantly as noted earlier. The domestic corporate sector showed a comparable growth in the volume of savings. Period IV savings were more than two and one-half times the volume of savings in Period I. Household saving was also two and one-half times greater in Period IV than in Period I. Net bank deposits showed the greatest growth of the components of household saving. In Period I they were -16.3 (Crores of Rupees) but grew to 48.2 in Period IV.

Capital formation has taken place on a large scale in India in the period 1960-66 at the same time that revenue collected has expanded enormously. The tax structure does not appear to have had any significant retarding effect on the growth of savings.

#### TAX STRUCTURE-DIFFERENCES

As noted earlier, India does not impose an excess inventory tax as recommended by Higgins. Sales taxes are relegated to the states and the central government uses a long list of commodities and services, taxed at many different rates, as its greatest single source of tax revenue.

The rates on commodities and services vary from nothing on necessities to two hundred per cent on certain luxury imports. This coincides with the approach that Higgins takes to indirect taxation.

The exemption of agricultural incomes from income taxation at the federal level is a weakness of the tax system of India. It has been noted that generally low agricultural incomes would contribute little to revenue collected, but in the interest of horizontal equity their exemption should be removed.<sup>32</sup> Income taxation is very severe in India, rates are high and progressive, but evasion is still as much of a problem as it was in 1957 when Kaldor estimated that it involved a tax loss to the Treasury of two to three billion rupees.<sup>33</sup> In the face of such widespread evasion Kaldor suggested that high income taxpayers be required to submit a comprehensive return showing income, expenditure, capital transactions and net worth. This would integrate all transactions, relating to a single taxpayer, in such a way that evasion would be impractical.<sup>34</sup>

Taxes on capital, particularly the net wealth tax, is a weak part of the Indian tax structure. Authorities have

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<sup>32</sup> Chelliah, pp. 121-22.

<sup>33</sup> Ibid., pp. 119-20.

<sup>34</sup> Kaldor, Indian Tax Reform, pp. 53-61.

continuously tried to perfect it and it was said in regard to the Government of India Budget for 1965-66:

The additional wealth tax on urban property is intended to serve as a deterrent to excessive investment in urban property and to divert such investment into more productive channels.<sup>35</sup>

In the list of exemptions to the tax on net wealth there are two highly questionable items. These are: (1) land, buildings, and other assets used in agriculture, and (2) personal assets which include works of art, household goods and animals. Incentives for development spending are provided for with exemptions from wealth tax of (1) investment in new and separate corporations, (2) certain shares of corporations, and (3) certain securities of government.

Few taxing measures have been so roundly condemned and yet survive as does the expenditures tax. It has been attacked from two points. First, the idea that expenditure is a better measure of ability to pay than income, has been called "a doubtful contention." Second, the records required of the taxpayer are "beyond his powers."<sup>36</sup> Another critic marshals a more extensive argument against it. He makes these points:<sup>37</sup>

- (1) The complexity of administration makes it unworkable in India because of the lack

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<sup>35</sup>Bulletin of the Reserve Bank of India, March, 1965, p. 287.

<sup>36</sup>Hicks, p. 106.

<sup>37</sup>Chelliah, pp. 131-35.

of trained personnel in the tax department.

- (2) The tax as recommended by Kaldor grants favorable treatment to all savings. An incentive to savings to flow into productive investment is needed.

- (3) The tax as introduced affects too few individuals to have the desired impact on national consumption spending and investment patterns. The tax affected only 6,000 of the 570,172 individual income taxpayers in 1958-59 when it was introduced.

A statement of the general feeling concerning the expenditure tax is found in the introduction to the Government of India Budget 1962-63:

. . . the Expenditure Tax is proposed to be abolished since it has been ineffective as a source of economic restraint, unattractive as a source of revenue and unpromising as a source of administrative control.<sup>38</sup>

One authority has commented on a propensity of economists, ". . . to recommend for adoption in underdeveloped countries devices too complex and controversial to be adopted at home, . . . ."<sup>39</sup>

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<sup>38</sup> Bulletin of the Reserve Bank of India, April, 1962, p. 530.

<sup>39</sup> Kindleberger, p. 242.

India abolished the Expenditure Tax as proposed in 1962 but revived it in 1964. This repeal and revival shows up in the statistics of revenue as a dip in collections in 1962-63 and 1963-64. Revenue from collections of the Expenditure Tax for 1965-66 was 0.75 (Crores of Rupees). First year, 1958-59, collections were 0.64.

The expenditure tax as adopted by the Central Government of India is different from that recommended by Kaldor and Higgins. The tax as proposed was to supplement the income tax and maximum rates of income tax were to be lowered. Rates of income tax have not been reduced to a significant extent. Higgins recommended that rates of expenditure tax be set at 6 to 20 per cent. Rates have been set to range from 10 to 100 per cent. The vigorous enforcement proposed by both Higgins and Kaldor has so far been beyond the capacities of the taxing authority of India. The use of computers in tax accounting has not been installed.

The list of exemptions from the expenditure tax is too long for inclusion but some of the items with doubtful legitimacy to claims for exception are:

- (1) Expenditure for the purchase and maintenance of livestock,
- (2) Expenditure for the marriage of the taxpayer or a dependent,
- (3) Purchases of books,
- (4) Expenses of seeking elective office in India.

In addition, the tax law of India allows the spreading of certain purchases, notably jewelry and gold bullion, over five tax years. These provisions seem to constitute a serious erosion of the tax base both for revenue and control purposes.

One critic accuses a spendings (expenditure) tax of ". . . providing an incentive to conceal assets," and making it ". . . advantageous to disguise personal expenses as business costs."<sup>40</sup>

The expenditure tax was repealed a second time by the Finance Act of 1966 which became effective April 1, 1966. At the end of the 1964-65 tax year more than 14,000 expenditure tax cases were unsettled.<sup>41</sup>

#### INCENTIVES

The industrial incentives in the income tax law of India fall into three groups:<sup>42</sup>

- (1) New industries are exempt from income tax for five years and dividends of corporations operating new industries are also exempt.<sup>43</sup>

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<sup>40</sup> Earl R. Rolph and George P. Break, Public Finance (New York: The Ronald Press Company, 1961), p. 189.

<sup>41</sup> Bulletin of the Reserve Bank of India, March, 1966, pp. 213-215.

<sup>42</sup> World Tax Series, India, pp. 282-86.

<sup>43</sup> Indian Investment Centre, pp. 27-44.

(2) All businesses may deduct a development rebate from business profits in the year new machinery and plant were acquired or installed. The development rebate varies with the kind of asset and date acquired.

(a) A 25 per cent of cost rebate is allowed on new machinery and plant installed after March 31, 1954.

(b) A 25 per cent of cost rebate is allowed on new ships acquired after March 31, 1954 and before January 31, 1958. After December 31, 1957 the rebate is 40 per cent of cost.

(c) The development rebate is in addition to depreciation and does not affect depreciation computation. Assets subject to development rebate, over their depreciable life, allow the taxpayer to deduct 125 per cent of their cost.

(3) Dividends which are received by a company from an Indian company that meets certain qualifications, such as date of registration, and engages in any of twenty industry categories, are exempt from supertax but not income tax.<sup>44</sup>

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<sup>44</sup>Ibid., pp. 71-73.

Interest paid to foreign lenders by businesses in India, and interest paid to nonresidents on certain loans guaranteed by the central government, are exempt from income tax.<sup>45</sup>

The exemptions to the income tax are incentives to invest. There are also incentives to honest and accurate filing of tax returns. By and large these incentives are lacking since the tax department still has no means of checking on underreporting of income except by sample audit of returns filed. In many cases taxpayers benefit from concealing transactions. Sellers do not report sales, leaving income understated, while buyers hold assets not reported for wealth taxation. Taxes are not interlocking so that a taxpayer can report one tax, say income, accurately and underreport another, say net wealth, with little fear of being detected. The incentive to save provided by the expenditure tax appears to be limited since the coverage of the tax is so restricted and the exemptions so numerous.

India has made a real effort to provide incentives to invest. Its tax laws are filled with tax exemption schemes. The value of the schemes is questionable and because their cost is indirect, revenue foregone, there is a tendency to favor them over direct subsidies.<sup>46</sup> These could be replaced

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<sup>45</sup>World Tax Series, India, pp. 234-38.

<sup>46</sup>Raynard M. Sommerfeld, Tax Reform and the Alliance for Progress (Austin, Texas: University of Texas Press, 1966), pp. 143-48.

with incentives that have a more restricted effect such as:

- (1) generous loss carryback and carry forward allowances,
- (2) accelerated depreciation rules and (3) preferential tax rates for reinvested profits.

If the tax structure is to be effective in promoting capital formation it must contain incentives to invest but the unwarranted favoring of new investment over established enterprise is a policy of which a government should be wary. Capital formation is not promoted by the attracting of firms which can survive only in a tax shelter and such firms usually leave at the end of an exemption period.

The economy has made a good record of growth over the period 1957-66 in revenue collected, saving and investment. India has compiled this record in spite of large scale poverty of the masses and external conflict. Especially notable is the large growth in household savings in spite of heavy taxation which indicates that the system of taxation has worked reasonably well.

## CHAPTER IV

### ECONOMICS OF WELFARE AND THE HIGGINS SYSTEM

The objective of this chapter is to examine the economic welfare implications of the Higgins proposal. What changes in the distribution of income are likely to occur following the adoption of such a system? What are the problems of adjustment that may occur? What will be the impact of these changes on consumers, workers, business firms and investors?

Adjustments in work effort, price and output, saving and consumption, and investment will vary with the imposition of a tax on income, capital or transactions.

The incidence and output effects of budget policy will be the first area of attention. These effects are based on the following relationships:

Public and private demand draw on the same total endowment of resources and share in the same output. Thereby they jointly determine relative prices of products and factors, the uses to which resources are put, and the way in which income is distributed. Similarly, the flow of public and private expenditures and receipts join to determine aggregate demand and hence the state<sup>1</sup> of employment and the general level of prices.

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<sup>1</sup> Musgrave, p. 205.

When taxes are imposed, the statute places the legal liability upon particular consumers or firms. When public expenditures are made, they go to purchase specific resources from specific markets or involve gifts to particular people. There is a clearly defined point of impact at which the public revenue or expenditure flow is inserted, but the eventual distribution of costs or benefits may differ greatly from the way in which the initial liabilities are placed. The final results depend not only on how budget payments are inserted into the system but on how the economy adjusts.<sup>2</sup>

There are three major economic consequences of budget policy. The transfer of resources from private to public employment is the first of the effects. Given a level of employment, an increase in the public demand for available resources reduces the resources available to the private sector. This represents the opportunity cost of satisfying public wants. Under conditions of full employment, resource transfer can be accomplished by requisition or payment and the source of finance will be a matter of indifference between taxes, borrowing or the printing press. Allocating the cost among individuals is determined by the choice of method of finance but the resource transfer is caused by the expenditure for goods and services.

"Resource transfer is a consequence of the expenditure and not the revenue side of the budget."<sup>3</sup> When the two sides of the budget are considered separately, we observe that,

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<sup>2</sup>Ibid., p. 206.

<sup>3</sup>Ibid., p. 207.

"resource transfer may occur without taxes, and taxes may be imposed without resource transfer."<sup>4</sup>

The second effect is the "resulting change in the distribution of income available for private use, which may be called "incidence."<sup>5</sup> Distributional changes may accompany changes in budget policy with or without resource transfer to public use. Consider first the case of resource transfer with full employment. An increase in public expenditures results in a transfer of resources which reduces real incomes in the private sector. The source of finance determines the distributional impact of the transfer:

- (1) If the source is credit creation and inflation the price level will rise. Some prices and earnings will lag.
- (2) If the source is income tax or excises, the result will differ.

Changes in budget policy without resource transfer are the second case. Assume full employment, new money finance (bank credit, printing press), and real expenditures by government constant, the price level will rise and the government's outlay in money terms will increase. There will be distributional changes because prices do not change at the same rate. However, no additional resources will be

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<sup>4</sup>Harl R.olph, The Theory of Fiscal Economics (Berkeley: University of California Press, 1954), p. 130.

<sup>5</sup>Musgrave, p. 207.

transferred to public use and there will be no change in resources available for private use. This result also holds if there is an increase in the price level as well as to substitutions between taxes of equal yield which leave the price level unchanged.<sup>6</sup>

Output effects are the third major consequence of budget policy. These effects are defined as changes in the level of output or real income resulting from changes in budget policy. Output effects may occur in the absence of resource transfer but when accompanied by resource transfer they may cushion or increase the resulting change in real income available for private use.

Changes in output in a full employment economy may come from:

- (1) Changes in technique,
- (2) Voluntary changes in labor supply,
- (3) Changes in saving and capital formation,
- (4) Efficiency of resource use.

The interdependence of the various types of change is noteworthy. All resource transfer, incidence and output effects are part of the same adjustment process. The relation may be stated:

Output effects bear upon the distribution of income and, hence, incidence. Distributional changes or incidence bear on the level of output. Both

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<sup>6</sup>Ibid., p. 208.

affect the steps required to secure a given resource transfer, and so forth.<sup>7</sup>

Incidence is not a function of changes in absolute prices but of changes in relative prices affected by (1) the structure of taxation and (2) market forces.<sup>8</sup>

The relation of resource transfer, incidence and output effects to specific changes in budget policy can be seen under the following conditions: (1) full employment, (2) public expenditures are constant in real terms, and (3) no change in resource transfer to public use. Changes in distribution can result from a change in a particular tax function. Suppose that income tax rates are cut. Income tax yield, in real and money terms, falls and the price level rises as private expenditures increase. Public expenditures must be increased in money terms to maintain real purchases.

Tax yields rise with the rising incomes but the initial losses are not fully recouped. The result of the inflationary process is a rising deficit in each round. The distributional change is a mixture of the initial pattern of tax adjustment and the distributional results of the inflation process.

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<sup>7</sup>Ibid., p. 209.

<sup>8</sup>Ibid., p. 370.

The distributional changes that result as one tax is substituted for another can be called "differential tax incidence" and compares the incidence of alternative methods of tax financing a given level of real expenditures. A more meaningful statement of its effects is, "Differential incidence is the difference in the distributional results of two tax policies that provide for equal yield in real terms." Tax policy deals with alternative methods of financing a given expenditure program within stabilization policy.

Incidence works through both tax and expenditure policy so that both collecting and spending taxes has effects on distribution. As the other side of differential tax incidence therefore we have differential expenditure incidence to designate changes in the distribution of income disposable for private use.

Assumptions of automatic full employment with equality of saving and investment do not hold in a compensatory system, since tax substitutions must be compatible with the objectives of stabilization. The distributional consequences of tax substitutions with private expenditures constant in real terms may be examined under three assumptions:

- (1) Tax substitutions may change the level of yield in real or money terms.
- (2) Resource transfer to public use is constant.
- (3) Differential incidence is a change measured in the level of deficit or surplus finance.

Here incidence deals with "the distributional consequences of alternative bundles of stabilization policies." These may be alternative packages of taxes, alternatives mixes of tax and monetary restrictions or the combinations of control devices. Tax incidence has now taken on a broader meaning than a measure of resource transfer through public expenditure.

Incidence is measured as it applies both to the group and the individual. We are most concerned here with changes as they affect groups of individuals, but we must not neglect the individual entirely.

Changes in distribution affect the individual through changes in his real income. Changes in real income reach him through his income stream which reflects on the sources side changes in the price he gets from the sale of his services, and on the uses side reflects changes in the prices he must pay for the products of others. Changes in budget policy reach him in the same way so both sides of budget policy must be considered in accounting for an individual's new position after a budget change.<sup>9</sup>

When confronted with a mass of individuals it is not feasible to follow the changes in budget policy as they affect specific individuals. Each individual has a different initial level of income, receives a different effect from

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<sup>9</sup> Ibid., pp. 218-22.

budget changes, and arrives at a later state with a different income not necessarily the same ratio with other individuals as in the initial period.

Grouping of individuals is a feasible way of measuring changes in distribution. For many purposes, renters, landlords, profit receivers, etc., which group individuals according to source of income, are used. This is essentially the group separation used in the continental type schedular income tax. However, in searching for a grouping pattern that reflects the makeup of the community, the simple size distribution of income offers the best alternative. The case for it is:

Incomes from various factors, especially labor broadly defined, accrue to recipients at high and low points in the income scale, and there is a growing tendency for people to receive incomes from a variety of sources. Thus the focus of the distribution problem has shifted to a size distribution of total income independent of its source. Accordingly, incidence as here defined refers to changes in the distribution of income by size brackets and not by factor shares. At the same time, there remains the significant fact that wages as a source of income decline in weight when moving up the income scale, while capital rises.<sup>10</sup>

Factor shares will still be the basis for analyzing changes in income position resulting from the sources side. Taxes which fall on wage income tend to affect low income taxpayers and taxes which fall on profits affect mostly

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<sup>10</sup> Ibid., p. 223.

high income taxpayers, although there is great variety in the factor shares in a size bracket.

The theory of factor shares can be set aside and incidence approached by size brackets of income. In this approach income recipients are arranged in order of size. The result can be plotted as a Lorenz curve. This is illustrated by Figure 1.

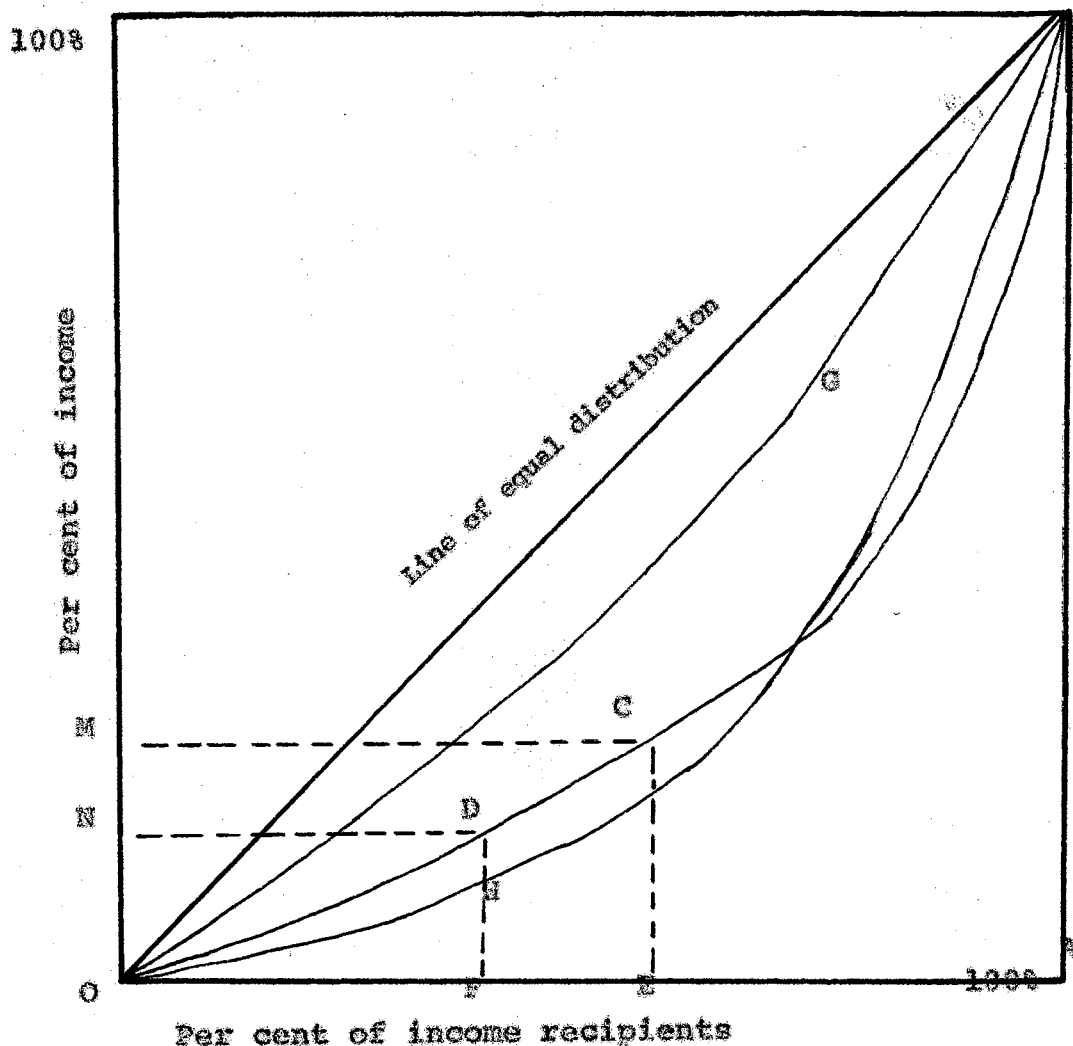


Figure 1. Distribution of Income

Initial distribution of income = ODB

1. Lowest per cent of income recipients = OF
2. Per cent of income of OF = ON

Assume that a change in budget policy results in a new state of distribution, OGB.

1. Coefficient of equality before the change,  $ODBA/OBA$
2. Coefficient of equality after the change,  $OGBA/OGA$
3. Ratio  $OGBA/ODBA$  measures the incidence or distributional changes:
  - a. Ratio exceeds 1: incidence is progressive.
  - b. Ratio equals 1: incidence is proportional or neutral.
  - c. Ratio is less than 1: incidence is regressive.

## ADJUSTMENTS OF WORK EFFORT

The distribution effects of a tax or taxes can be examined as a choice between income and leisure. In the absence of a tax the individual chooses between work and leisure to maximize his satisfaction by balancing an amount of leisure against the income he could derive from working a like period. Indifference curve analysis will help to demonstrate these choices and show how work effort is affected as one tax is substituted for another.

Figure 2 shows adjustments in work effort as tax substitutions are made. Assuming that all income is work income, equilibrium without tax is at point C where income received is OE, leisure retained is OD, and hours worked DA. The placing of a proportional tax changes the slope of the wage line of AF, leisure increases from OD to OH shifting equilibrium to point G so that tax yield is EK. Since a proportional tax takes a constant percentage of income the increased preference for leisure is noticeable but not severe. Substitution of a progressive tax for a proportional tax changes the slope of the wage line downward to AL with the new equilibrium at point M where tax yield, MR, is equal to EK. The taxes have equal yields.

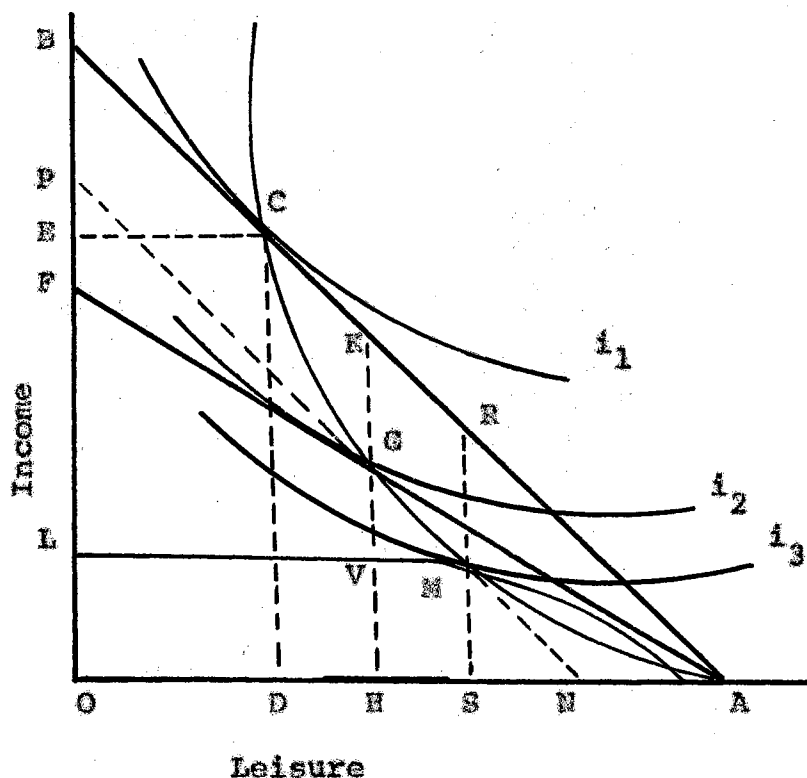


Figure 2. Adjustments in Work Effort

Assume that all income is in the form of work income.

1. Leisure = OA
2. Wage Line = AB
3. Pre-tax equilibrium = C
4. Distribution:
  - Income received = OE
  - Leisure retained = OD
  - Hours worked = DA
5. Equilibrium with proportional tax:
  - New net wage line = AF
  - Leisure increased, OD to OH
  - Income before tax = EK
  - Taxes paid = GK
  - New equilibrium = G
6. Equilibrium with progressive tax:
  - New net wage line = AL
  - Taxes paid = MR
  - Leisure retained = OS
  - New equilibrium = M

Where taxes of equal yield are imposed, a proportional tax reduces work effort but a progressive one reduces it more. Where both taxes increase work effort, the progressive tax increases it less than a proportional tax.<sup>11</sup>

Adjustments to a change in taxes are more complex when applied to a group. In substituting the two taxes treated above, both of equal yield, we would find the following behavior:

- (1) Low income recipients either reduce or increase work effort depending on reductions in their marginal and average tax rates.
- (2) High income recipients find their average and marginal rates increased so they may either increase or decrease work effort.
- (3) Middle income recipients find their marginal rate unchanged and their average rate reduced so they reduce work effort.

The differential effects of alternative tax schedules on the total labor supply are a much more complex matter than such effects on the work effort of the individual taxpayer.<sup>12</sup>

A new set of adjustments is needed if allowance is made for capital income and income taxation. Two results are observed:

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<sup>11</sup>Ibid., p. 243.

<sup>12</sup>Ibid., p. 246.

- (1) The level of work effort is higher if the tax is on income from old capital rather than work income.
- (2) A tax on capital income has the same effect as a tax on capital if all capital is income-earning.

Generally the presence of capital income results in the reduction in work effort, caused by a progressive tax, being less severe than if only wage income is present. A corporation income tax may be considered a special case of a tax on capital since it affects the shareholder in the manner of a direct tax on capital income by reducing dividends or by reducing retained earnings.

Succession duties, estate and inheritance taxes, are roughly equivalent to current income taxes.

The effect on work effort of a tax on consumption or spending compared to the effect of a flat rate tax on income depends on the relative value of consumption and work effort. Work effort is higher under the consumption tax if future consumption and work are complementary, while present consumption and work effort are rival; it will be higher under the income tax if the relation is reversed.

The behavior of taxpayers as a group suggests that work effort will be higher under a proportional spendings tax than under a proportional income tax. Spending as a

per cent of income declines when going up the income scale, which makes the tax regressive in terms of income.

The effect of a partial tax on consumption would affect consumers and their work effort differently. Low income taxpayers with budgets weighted with necessities would probably react quite differently from high income taxpayers whose budgets are weighted with luxuries.

The significance of changes in work effort should be stated in the light of the goals of budget policy which may not be to maximize work effort. Since the level of work effort bears on the level of output, policy should at least avoid positive disincentives to work effort.<sup>13</sup>

#### PRICE AND OUTPUT

Adjustments in price and output to a change in taxes should take three forms:<sup>14</sup>

- (1) Short run changes in price and output with plant capacity unchanged. This generally entails action to raise price and lower output.
- (2) Long run changes are made in plant capacity.
- (3) Cost payments are reduced for services and materials.

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<sup>13</sup>Ibid., p. 256.

<sup>14</sup>Ibid., p. 277.

Output effects which work through changes in technique or efficiency of resource use can occur without a change in real yield or resource transfer as one tax is substituted for another.

Figure 3 illustrates the relationship of changes in price and output in a competitive model with ad valorem taxation. India, with its heavy taxation of commodities and services with a wide range of ad valorem duties, is especially suited for the study of actions in this model. Figure 4 applies to the same model with a unit tax.

#### CONSUMPTION AND SAVING

All taxes have an income effect because they tend to reduce consumption. A progressive income tax reduces saving more and consumption less than a proportional tax whether the proportional tax is on income or consumption. Noticeable dissaving occurs at the lower end of the income scale.<sup>15</sup> A proportional tax on wage income falls more heavily on consumption than the same tax on capital income. A proportional tax on wage income is regressive, on capital income it is progressive because the wage to capital income ratio shifts increasingly toward capital income when moving up the income scale.

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<sup>15</sup> Ibid., p. 270.

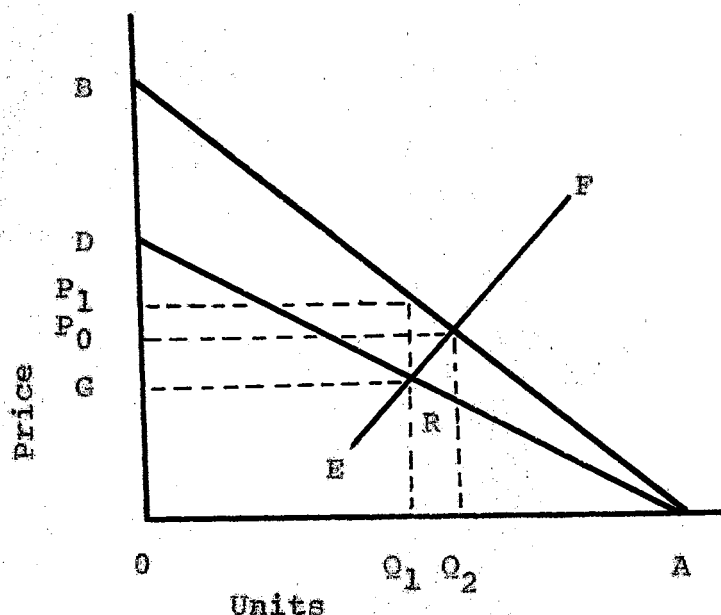


Figure 3. Price and Output

Actions in a competitive model with ad valorem tax:

- Case 1: Profits are cut so a tax on profits here is the same as a tax on capital income.
- Case 2: Prices are raised so a tax on profits is similar to a tax on gross receipts or consumer expenditures.
- Case 3: Wages are reduced so taxes on profits is the same as a payroll tax.

Industry demand schedule = AB  
 Demand schedule after 50% ad valorem tax = AD  
 Supply schedule = EF  
 Pre-tax price =  $P_0$   
 Post tax price =  $P_1$   
 Revenue = R

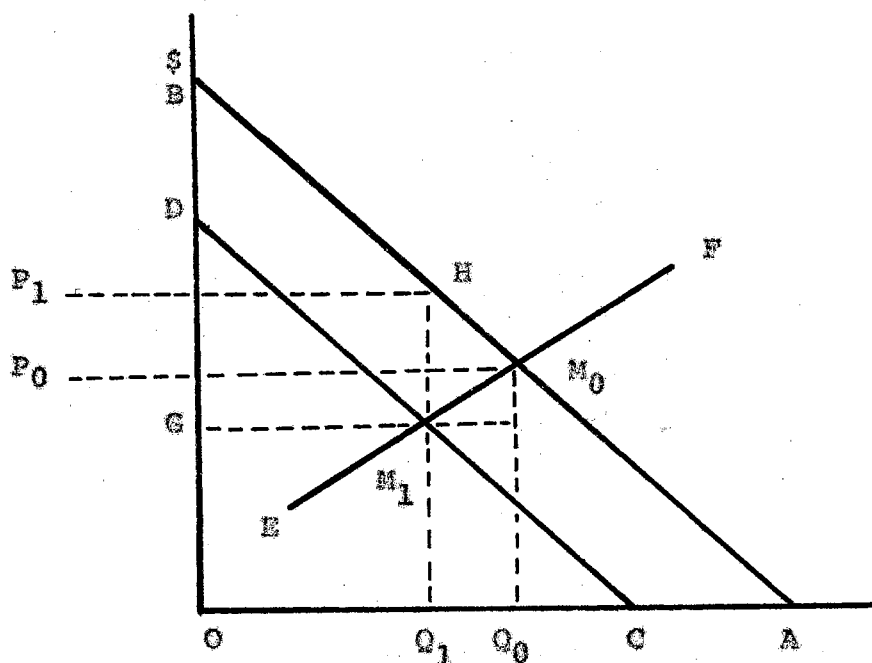


Figure 4. Price and Output

Competitive model: Unit tax - Unit cost rises by a constant amount for all levels of output.

Industry demand schedule = AB

Industry demand schedule after tax = CD

Unit tax = B - D

Industry supply schedule = EF

Pre-tax price =  $P_0$

Post-tax price =  $P_1$

Conditions and Resulting Adjustments:

Constant Cost: The increase in price = the unit tax.

Increasing Cost: The increase in price is less than the tax.<sup>16</sup>

Decreasing Cost: The relationships are reversed.

Initial equilibrium =  $M_0$  Post tax equilibrium =  $M_1$ <sup>17</sup>

<sup>16</sup>Musgrave, p. 306.

<sup>17</sup>Ibid., pp. 288-89.

Assume a model in which the supply of effort is fixed. All income is consumed or saved and there are no substitution effects.<sup>18</sup> The institution of a tax shifts  $C$  downward to  $C_1$  indicating a reduction in consumption at all levels of income. The slope of  $S$  is changed to  $S_1$  showing a reduction in saving in the upper levels of positive income. Equilibrium of  $Y$ ,  $C$ , and  $S$  is shifted downward from  $A$  to  $A_1$  and saving is zero. These relationships are shown in Figure 5.

When the imposition of a tax reduces income available for consumption, taxpayers reduce saving to try to maintain existing levels of consumption. When saving becomes zero taxpayers are forced to accept a reduction in consumption.

#### INVESTMENT

Taxation of business profits through a tax on net income may result in constant price and output while the tax is allocated between dividends and retained earnings with long range adjustments in the kind and level of capital investment.<sup>19</sup> The flat rate corporation income tax may have such an effect.

To analyze general investor behavior, we must look at his decision as a choice between risk and yield. The investor's preference between risk and income determines the

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<sup>18</sup> Joseph P. McKenna, Aggregate Economic Analysis (New York: Dryden Press, 1955), p. 41.

<sup>19</sup> Musgrave, p. 411.

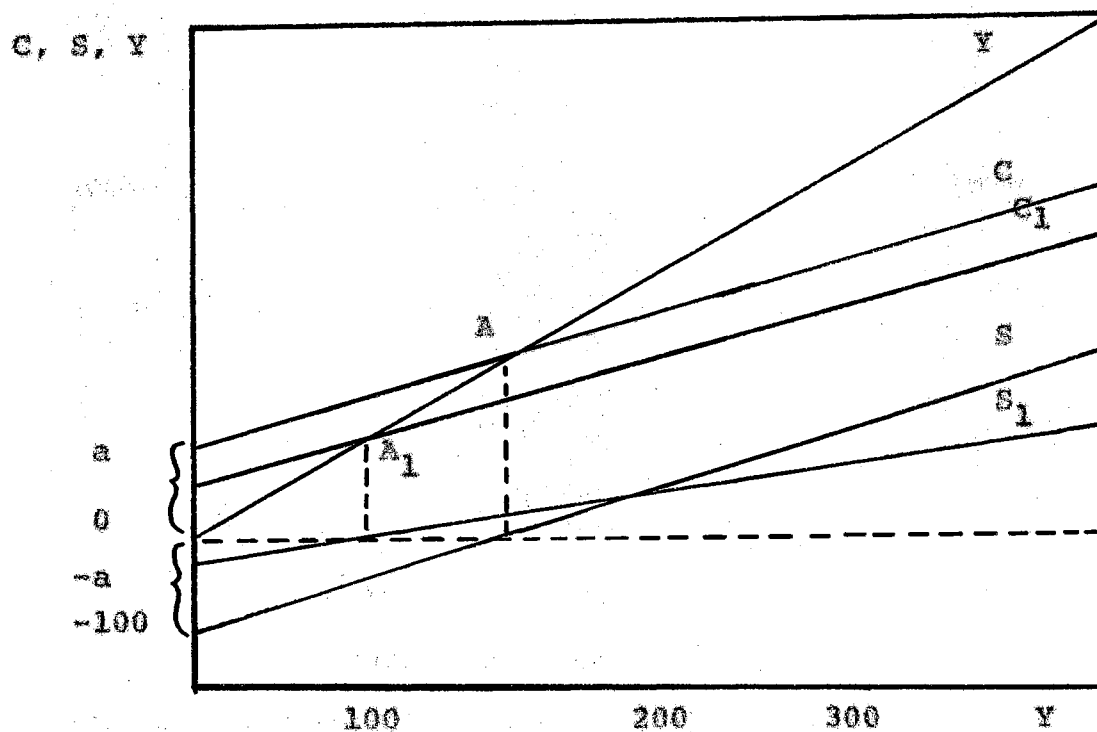


Figure 5. Consumption and Saving

Assume:

- Fixed supply of effort
- All income is consumed or spent
- No substitution effect

Y = Income

C = Consumption

S = Saving

$$\begin{aligned}
 S &= Y - C \\
 &= Y - (a + bY) \\
 &= Y - bY \\
 &= -a + (Y - bY) \\
 &= -a + (1 - b)Y
 \end{aligned}$$

size of the portfolio of assets he will hold. Comparison can be made of the taxpayer's preference in a case without tax and the tax allowing loss offset.<sup>20</sup> The case of investor behavior without tax is illustrated in Figure 6 and the case of investor behavior with income tax without loss offset is shown in Figure 7.

### STABILIZATION

Earlier we discussed simultaneous goals of: (1) price level stability, (2) full employment, and (3) an equilibrium rate of growth. These are the normal objectives of stabilization policy and they are as relevant to the underdeveloped countries as to any modern economy. However, the implementation may need to be modified as it is applied in the former case. The effectiveness of tax policy based on the Higgins system needs to be discussed in relation to its expected role in stabilization policy.

Assuming growth in capital formation, changes in distribution which affect taxpayers with different marginal propensities to consume, result in a change in the rate of growth as taxes are increased. In any case the "Substitution of loan finance for proportional income tax

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<sup>20</sup> Ibid., p. 419.

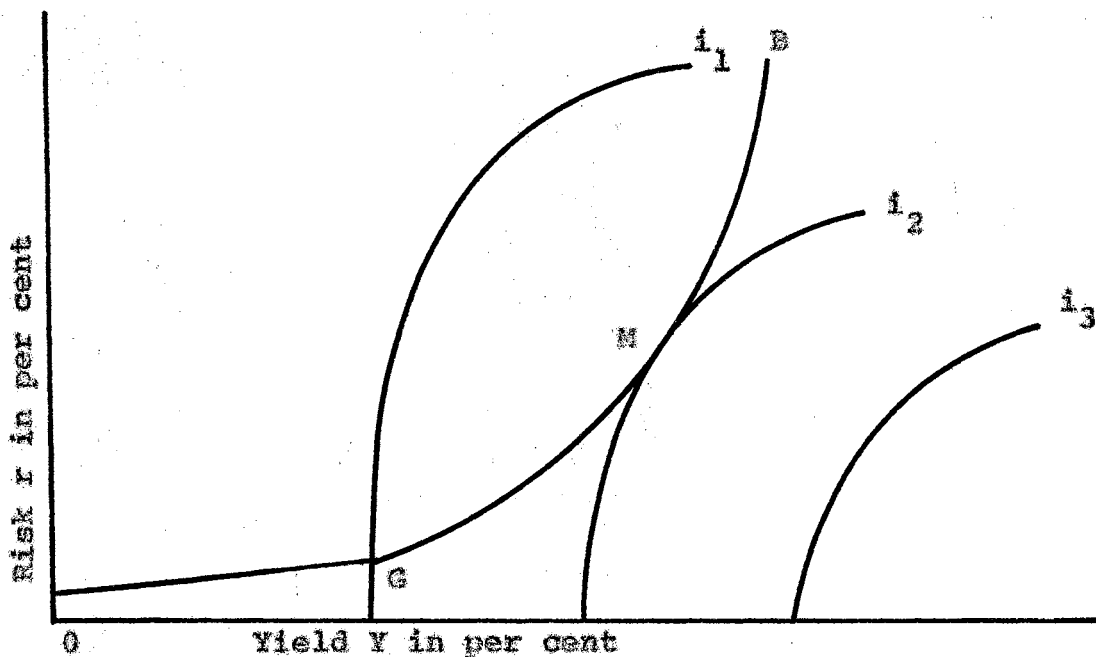


Figure 6. Investment

#### Optimum Asset Curve (OGB) Without Tax

1. Investment choice on all points on OGB is determined by preference between risk ( $r$ ) and income ( $Y$ ).
2. Size of the asset portfolio is given, values  $Y$  and  $r$  are percentages.
3. Marginal utility of income falls with rising income and marginal disutility of risk rises with increasing risk.
4. The slope of the indifference curves is positive.
5. The investor chooses the highest possible indifference curve which is at point M.

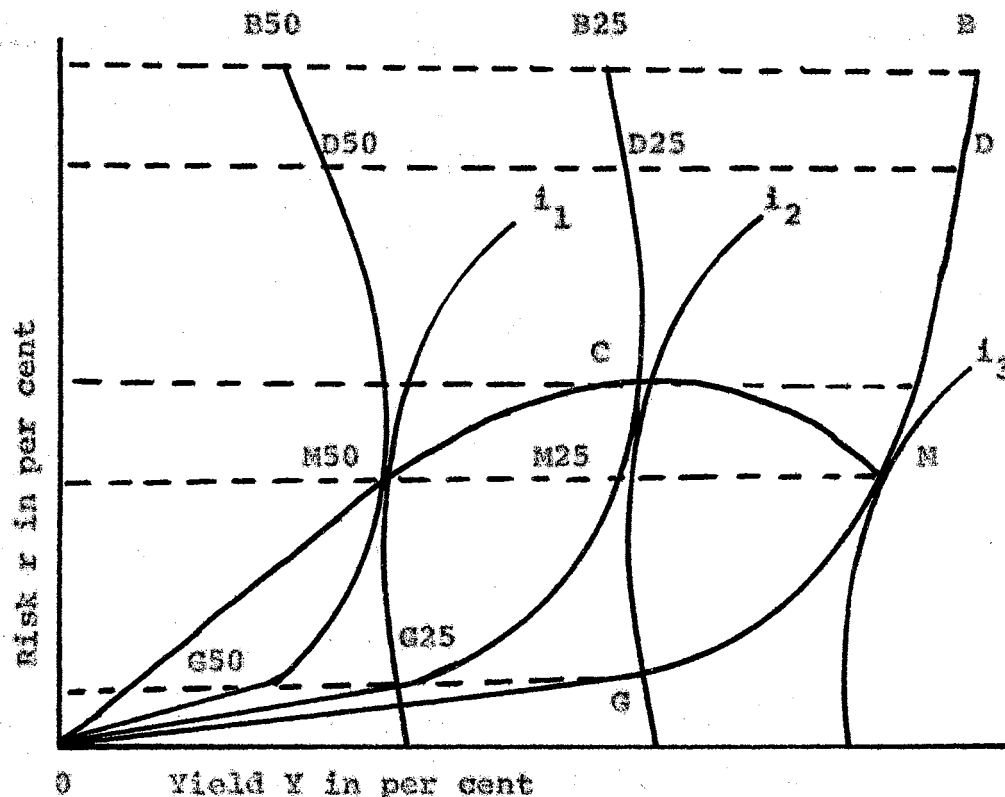


Figure 7. Investment

Optimum Asset Curve (OGB) With Income Tax Without Loss Offset

1. Pre-tax optimum asset curve = OGB
2. Pre-tax equilibrium = M
3. Imposition of a tax causes each point on OGB to shift horizontally to the left because  $y$  is reduced while  $r$  is unchanged.
4. MGO is the equilibrium path as rates of tax are increased.
5. Income effect versus substitution effect:
  - a. The income effect pushes the investor toward more risk to try to recover income.
  - b. The substitution effect pushes the investor toward less risk as the reward for risk taking falls.
  - c. Initially the income effect is stronger but weakens as the tax rate increases until an all cash position is reached at a tax rate of 100%.

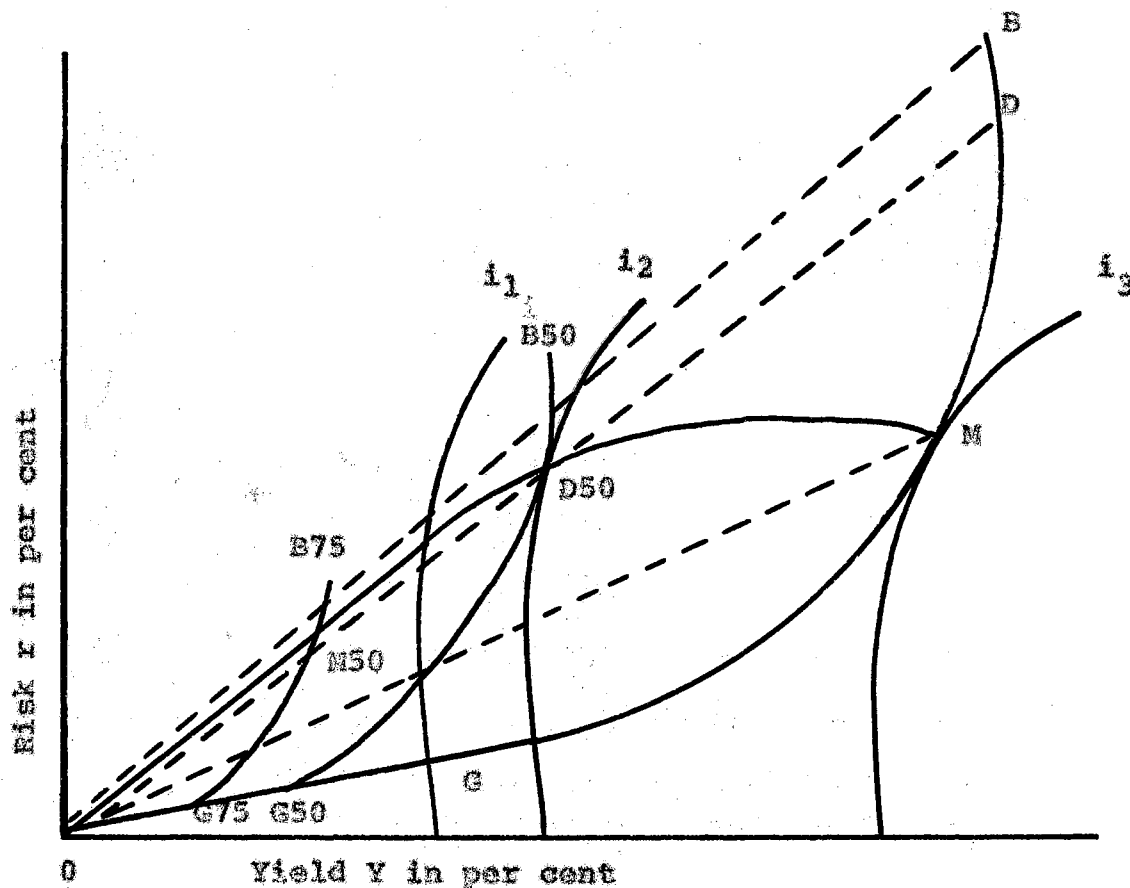


Figure 8. Investment  
Income Tax With Full Loss Offset<sup>21</sup>

Assume that the Treasury refunds losses at the rate of tax applicable to gains.

1. Pre-tax equilibrium = M Optimum asset curve = OGB
2. Both  $r$  and  $y$  are reduced at the same rate by imposition of a tax which moves each point on OGB toward the origin on a straight line.
  - a. 50% tax: Optimum asset curve becomes  $OG_{50}B_{50}$
  - b. 75% tax: Optimum asset curve becomes  $OG_{75}B_{75}$
3. Equilibrium movements:
  - a. 50% tax: M to  $M_{50}$  (not an equilibrium point) to  $D_{50}$ .
  - b. 75% tax: Movements will be the same as before. The investor will move up  $OG_{75}B_{75}$  to a point of tangency with an indifference curve applicable to the size of a given asset portfolio.

<sup>21</sup>ibid., pp. 320-22.

finance will reduce private capital formation as loanable funds are diverted into public debt."<sup>22</sup>

Unemployment equilibrium may occur because of an insufficient money supply. The level of needed investment may not be achieved because interest rates are too high and the rigid money wages permit no increase in the supply of asset money by "bidding down money wages."<sup>23</sup>

Interest rates may be lowered and investment raised by increasing the supply of money. Both fiscal and monetary policy may be effective in this system but together they will be more effective than either would be alone.

Expansion with a balanced budget policy results in the following adjustments: (1) income grows, (2) funds are drained from asset to transaction use, (3) the rate of interest increases, (4) investment declines, and (5) the decline in investment offsets the increase in income. If the adjustments had been the result of deficit finance with borrowing from the public, the check to investment would be stronger as the interest rate is driven higher by the increase in the supply of public debt.<sup>24</sup>

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<sup>22</sup> Ibid., p. 411.

<sup>23</sup> Ibid., p. 419.

<sup>24</sup> Ibid., pp. 419-22.

## INVESTMENT AND ADJUSTMENTS IN TAX STRUCTURE

Adjustments in tax structure may be used to shift the tax burden between income subject to consumption and income which is primarily devoted to investment.<sup>25</sup> The objective of maximum investment set by Higgins combined with the goal to increase tax yield needs to be considered:

A tax system that bears heavily on people with high propensities to consume acts as a relatively heavy brake to expansion, if the expansionist policy involves an increase in yield.<sup>26</sup>

Changes in investment, by their effects on the level of aggregate demand, determine the level of income, employment and prices. Saving is offset by investment in the Keynesian sense. Considered in this environment stabilization policy deals with maintaining a stationary level of full-employment income with a stable price level.

Investment provides additions to capacity so that under conditions of full employment, growth in income is generated. This second role of investment requires a different view of stabilization policy. The relevant policy is here one of attaining a growing level of capacity income at stable prices. Selection of the most appropriate rate of growth is a further complication.

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<sup>25</sup>Ibid., p. 493.

<sup>26</sup>Ibid.

Expansion of the capacity to produce grows with increased investment and must result in income growth if full employment of resources is to be maintained. Increased demand is furnished by growth of expenditures. If the rate of growth in expenditures exceeds the rate of growth required to maintain full employment, inflation will result. If the expenditure rate of growth is less than the required rate of growth, resources are not fully utilized. Labor will become unemployed and prices will fall. Stabilization policy aims at equating the two rates of growth.<sup>27</sup>

The determination of the required rate of growth is found as follows:

- (1) The fraction of government expenditure that goes into capacity-increasing investment is a crucial element in the determination of the required rate of growth. If the relation is 1:1, changes in the fraction of total income which is government expenditure (g), have no bearing on the required rate of growth. The only change is in the division of investment between the public and private sectors. If the fraction of government expenditures going into capacity-increasing investment is less ( $r < 1$ ) than 1, the

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<sup>27</sup> Ibid., p. 484.

required rate of growth declines as the fraction (g) increases. This means that resources are being transferred from private to public investment use.<sup>28</sup>

- (2) Capacity growth is faster if investment spending is done by whoever channels a larger fraction of his income into investment. Private investment does not automatically equal the required rate of growth. The required rate is a specific function of the level of past income.
- (3) The appropriate fiscal adjustment for the maintenance of balanced growth in the face of a potential inflationary gap is to raise the rate of tax or to lower government expenditures which moves the required rate of growth and the expenditures rate of growth closer together.<sup>29</sup>

If the balanced rate of growth is at equilibrium but it is desired to move to higher or lower rates of growth, both the rate of tax and government expenditures must be changed in the same direction.<sup>30</sup>

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<sup>28</sup> Ibid., pp. 485-86.

<sup>29</sup> Ibid., p. 490.

<sup>30</sup> Ibid., p. 492.

# UNEMPLOYMENT INFLATION AND CAPITAL SHORTAGE

Three pernicious influences in developing economies: unemployment, inflation and capital shortage, need to be considered in models of growth. Assume that wage rates and prices are rigid against any downward movement so that the full labor force cannot be employed by the existing capital stock at the prevailing real wage rate. The elimination of unemployment means reducing consumption, increasing saving, and increasing investment. The program needed to accomplish it is one which shifts taxes on investment to taxes on consumption. An alternative approach is a budget surplus which would permit additional private investment by credit expansion. This means:

As the supply of capital is increased relative to that of labor, a larger labor force<sup>31</sup> can be employed at the given real wage rate.

Raising real income to overcome unemployment requires an increase in capital not simply a rise in the level of aggregate demand. Transferring resources to capital formation through inflation results in (1) an inefficient choice of investment and (2) an inequitable allocation of the burden. The transfer is best accomplished without inflation, a transfer of demand without addition to demand, and the choice of investment channeled according to a chosen priority.

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<sup>31</sup>Ibid., p. 497.

The situation with regard to unemployment, inflation and capital shortage in underdeveloped countries has been analyzed in this unique statement:

The basic problem is not one of unemployment to begin with: it is one of low productivity due to capital shortage and a resulting real wage rate so low that a high level of leisure is preferred. What appears to be a high level of unemployment is, in fact, a situation of poverty with full employment in the classical sense.<sup>32</sup>

The Higgins Self-Enforcing Incentive Tax System has a mixture of effects as far as the problems of unemployment, inflation and capital shortage are concerned. It has adequate controls for controlling consumption and provides both controls and incentives for investors. Taxes on consumption expenditure coupled with tax relief for approved investment expenditure should result in the needed shift as the analysis of discriminatory taxes demonstrated.

#### INCENTIVES

Tax incentives have a number of forms. First, the exemption of new investment from taxation for certain periods is designed to attract new investment into potentially high risk areas. Second, liberal depreciation allowances, income averaging and other devices designed to lower the risk factor are extended to attract investment. Third, the penal aspects of incentive taxation are important. Investment is

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<sup>32</sup>Ibid.

discouraged in certain lines by the imposition of a tax when such investment is detrimental to fiscal or monetary goals.

Higgins counsels against exempting new investment from taxation. Tax exemption cannot make unprofitable ventures profitable and profit making ventures do not need exemption. Blanket exemption of new investment would not necessarily draw investment into development projects, so tax freedom should be extended only with extreme caution.<sup>33</sup>

Varying tax rates selectively is the preferred course to controlling the allocation and timing of investment. Accelerated or deferred depreciation is useful. Another device is to allow certain profits to go untaxed but require them to be invested in non-negotiable non-interest-bearing bonds.

The most important utilization of incentive taxation in the Higgins system is the penal tax provisions. These taxes are not meant to be collected. Their purpose is to persuade people to take certain action to avoid incurring the liability.<sup>34</sup> Taxes on excess inventories and cash balances are examples of incentive taxes with penal features. Taxing productive assets at rates approaching zero is designed to draw investment from speculative hoards of cash,

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<sup>33</sup>Higgins, p. 515.

<sup>34</sup>Ibid., p. 517.

business inventories and unused land into critical development projects.<sup>35</sup>

Tax exemption has serious limitations as a stimulus to investment in a developing country. Some of the limitations are:<sup>36</sup>

- (1) Discriminatory taxation between manufacturing and non-manufacturing favors the latter. Tax exemption of new investment in manufacturing merely equalizes the burden between the two sectors and provides no incentive. A preferred course would be to simply increase taxation of the non-manufacturing sector.
- (2) Investment gained by tax exemption is removed from the tax base so a heavy burden must be shouldered by other taxpayers.
- (3) The aggregate of private domestic capital formation probably will not increase as a result of a tax exemption device. A shifting between alternative employments of capital is all that can be expected.
- (4) Tax exemption will not of itself draw investment to needed development areas.
- (5) A firm may secure a monopoly position via tax exemption.

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<sup>35</sup>Ibid., p. 518.

<sup>36</sup>Sommerfeld, pp. 143-47.

- (6) Once granted, tax exemption tends to become imbedded in the structure of the economy and proliferates to other developing countries in the competition for new investment.
- (7) Tax revenue foregone is a real cost of exemption.
- (8) The difficulty of administration is a serious handicap.

These reasons are sufficient to make a good case against indiscriminate tax exemption. The view of one authority is:

A country which wishes to embark on incentive legislation in a big way should scrutinize very carefully each application in order to satisfy itself that the proposed new enterprise is a sound proposition which will really contribute to the growth of the economy.

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<sup>37</sup> Hicks, p. 101.

## CHAPTER V

### SUMMARY AND CONCLUSIONS

The main source of saving and investment is the domestic economy. The problem is to discover, mobilize and direct savings into the desired projects by preventing leakages into luxury consumption or sterile investment in traditional high unit profit industries. We have examined the composition, administration and effects of the tax system which Professor Higgins has designed for dealing with the problems of financing a program of economic development.

Any comprehensive redrafting of the tax laws with a concerted program of enforcement would be likely to increase tax revenue and the recommendation by Higgins that vigorous enforcement be made the cornerstone of his system is likely to more than satisfy this goal.

The basic reasons for the poor past performance of the tax systems in most underdeveloped countries appear to be: (1) lack of confidence in government, (2) lack of trained officers, and (3) poorly drafted tax laws.<sup>1</sup> A program of improved collection begins with the basic

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<sup>1</sup>Hicks, p. 67.

machinery of collection and an appreciation of the positive contributions which taxes make to the development process. The most important of these contributions are: (1) transfer of resources to the government, and (2) balancing supply and demand in the economy. For taxation to be an effective fiscal agent, securing the necessary resources and balancing supply with demand, two conditions must exist: (1) Revenue as a percentage of national product must be sufficiently large to influence the level of economic activity in general and consumption in particular. A rate of about twenty per cent of gross national product is a fair estimate.<sup>2</sup> (2) As incomes rise the government automatically secures an increasing proportion of them. Marginal tax incidence is higher than average tax incidence which means a noticeable degree of progressivity in the tax structure.

The concerted attack on avoidance, the suppression of evasion and the comprehensive coverage of the tax system should assure the production of increased revenue.

#### INFLATION

Applying fiscal controls to check inflation has been opposed by the following arguments:<sup>3</sup>

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<sup>2</sup> Ibid., p. 69.

<sup>3</sup> Musgrave, pp. 467-71.

(1) High taxes are a cause of capital shortage; therefore, taxes on investment cannot be used to check inflation because they curtail capacity thereby reducing available supplies.

Two cases can be distinguished:

(a) A tax which reduces investment is introduced into a situation where no tax existed.

(b) A tax which reduces investment is compared to a tax which reduces consumption by the same amount. Case "a" results in immediate reductions in expenditures but a gradual loss in capacity. The new effect is deflationary. Case "b" is deflationary immediately as a consumption tax replaces an investment tax.<sup>4</sup>

(2) High taxes are a cause of spending. A profits tax encourages business spending. A profits tax cannot be used to control inflation. The case is argued that deductions from taxable income, for labor, plant and materials, reduce their new cost which encourages spending.

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<sup>4</sup>Higgins, p. 468.

The problem here is a faulty definition of income, not high taxes. A high level of tax rates makes application of a concept of income more difficult since evasion is more profitable.

- (3) Cost-push inflation is not susceptible of control. Fiscal controls are well adapted to deal with inflation if the problem is one of checking excessive demand. However, in cost-push inflation equilibrium cannot be restored by checking demand. Powerful sectors of the economy administer prices by such devices as percentage markups on wage costs. The choice confronting fiscal authorities is that of underwriting inflation or checking aggregate demand but imposing unemployment.<sup>5</sup> High employment and a stable price level are incompatible in such circumstances. Wage increases must then be held to equal increases in productivity.<sup>6</sup> The tax to be imposed should fall on consumption rather than investment.

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<sup>5</sup> Masgrave, p. 470.

<sup>6</sup> Ibid., p. 471.

- (4) Another check to inflation is built-in flexibility of a progressive tax system. It would be a brake on efficiency. The place for progression is personal income taxation.<sup>7</sup>

Higgins has dealt with the control of inflation in his system by the measures to control hoarding of currency and goods. By forcing all available supplies on the market by taxes on excess inventories, any price rise should be moderate. The taxes on assets, especially land, should curb this always fertile source of speculation.

#### INVESTMENT

Investment can be increased because the government secures a larger share of the resources available in the economy. Private investment is reinforced with public investment, most of which comes out of private consumption. The government secures a larger share of the economy's resources to invest in development at the same time that curbs on consumption spending have made a larger share of the private resources available for investment. By attacking the problem on two fronts leakages and wastage should be minimal.

A key device for the channeling of investment in the Higgins plan is a tax on expenditure. This tax is viewed

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<sup>7</sup>Hicks, p. 99.

unenthusiastically by Hicks.<sup>8</sup> She questions the underlying presumption that ability to pay is measured more accurately by what is spent rather than what is received.<sup>9</sup> The encouraging of saving by the wealthy is the purpose of the tax. In effect it is like an income tax. As proposed by Higgins it is not primarily a revenue collecting device.

Enormous difficulties have been experienced in discovering and assessing the wide range of personal expenditures to which the expenditure tax applies. Attempts have been made to overcome these difficulties with a system of interlocking taxes. By requiring a consolidated tax return, the taxpayer would reveal all his transactions or have them revealed by parties with adverse interests on their returns. The level of tax administration in developing countries appears to be unable to cope with the kind of record keeping necessary to make this approach workable. India has experimented with it for several years, but Ceylon, after a brief trial, abandoned the expenditure tax.<sup>10</sup>

Hicks believes that channeling investment into development should be left to monetary policy with the principal agent being the central bank.<sup>11</sup> The action of the

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<sup>8</sup>Ibid., p. 106.

<sup>9</sup>Higgins, p. 323.

<sup>10</sup>Hicks, p. 106.

<sup>11</sup>Ibid., pp. 51, 54-58.

bank is to channel to development the sources of saving: (1) savings from public reserves, and (2) the purchase of savings certificates and similar securities by the general public. The bank should have all the powers necessary (1) to change reserve requirements, (2) withdraw funds from circulation, and (3) to encourage investment through selective credit controls in particular lines. Economic development is important enough to generate the setting up of a sound commercial banking system.

The provision of credit facilities as an incentive for economic development has an inflationary effect but the lack of such facilities may be an even more serious restraint on expansion.

The tax on assets is also designed to channel investment. The rates diminish "with the degree of risk and illiquidity assumed."<sup>12</sup> The rates on cash are highest, on productive assets they approach zero, in the hope that saving will be diverted from cash balances to productive investment.

A broadly based channeling device would be a tax on all purchases. Luxuries could be covered with high rates while necessities would have low, or zero, rates. Purchases of capital goods would be exempt which would give them substantially the same treatment which they usually receive

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<sup>12</sup>Higgins, p. 508.

under progressive income taxation through depreciation allowances. The effect is to partially exempt saving, or at least that part spent on capital goods purchases, from taxation.<sup>13</sup> Chelliah summarizes Kaldor's argument for an expenditure tax and rejects it.<sup>14</sup> While the expenditure tax would treat savings more favorably than an income tax, Chelliah prefers an income tax with a partial exemption for saving.

Besides the curb of the expenditure tax, the inducement of lower rates of taxation on productive assets should persuade savers to use their funds to foster development projects. If these measures are coupled with provisions for allowing losses to be carried forward and back against income, the program for channeling investment should be very compelling.

#### CAPITAL FORMATION AND TAX POLICY

The experience of the Indian economy in the years 1956-1966 suggests that programs for increasing capital formation and programs to secure a greater share of the national income for public use through tax policy may be compatible.<sup>15</sup>

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<sup>13</sup>Chelliah, p. 91.

<sup>14</sup>*Ibid.*, pp. 127-35.

<sup>15</sup>Harley E. Hinrichs, A General Theory of Tax Structure During Economic Development (Cambridge: The Law School of Harvard University, 1966), pp. 111-117.

Savings and investment more than doubled over the period while tax revenue was increased threefold. Significantly, the greatest share of the increase in savings accrued to the household sector.

If capital cannot be raised from sources from abroad, capital formation can be accomplished by increasing government revenue and curbing government expenditure for consumption. The political difficulties of reducing the latter are illustrated by the experience of Ceylon. An announced policy change that the government would no longer subsidize the price of rice to consumers led to a rapid change of government. The capacity to tax will be the largest determinant of the ability of a country to increase capital formation.<sup>16</sup>

The tax program to accomplish capital formation must utilize taxes which restrain consumption to a greater extent than it uses taxes on income. The disincentive effect of income taxes retards capital accumulation and the plowing back of profits. Consumption taxes can be made progressive by exemptions from tax for necessities and the application of heavy rates for luxuries so that regressive effects are not serious.

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<sup>16</sup>Kindleberger, p. 240.

## CONCLUSIONS

By imposing a tax on each alternative use of funds the Higgins system forces individuals to invest as the only escape from taxation. Merely investing is not sufficient. A list of high priority investments is provided so that complete avoidance of tax means investing in specific projects. In this way the savings in the economy are mobilized into those high priority projects deemed most necessary for economic development.

This approach could break down from two sides. First, the level of private saving in the economy may be low so that most investment may have to come from the government sector until incomes are raised sufficiently to permit significant private saving. Saving, even at very low income levels, exists but it may be too little to affect the investment picture. Second, low priority but high profit investments may be so lucrative or enforcement may be so weak that investors will either pay the alternative taxes or evade them and ignore investment in the approved projects. If these undesirable events are to be prevented, the administration of the tax system must be flexible enough to change tax rates and make other adjustments to assure that the approved projects present an attractive alternative to luxury spending and speculative investment. Otherwise, investors will weigh the choices and elect consumption spending, non-approved investment or cash holdings.

Fiscal policy, based on a scheme of exempting approved investment from taxation of income, lends support to the Higgins argument.<sup>17</sup> Investment in equities and government securities is particularly encouraged. Three rates of exemption, distinguishing government bonds, equities of corporations, and capital gains, the latter treated most leniently, are suggested.<sup>18</sup> Two objections to the exemption scheme are: (1) the loss in tax revenue, and (2) economic inequalities may be increased.<sup>19</sup> If the exemption promotes investment, greater tax yield may result from increased business profits. Coupled with the taxation of incomes that now escape taxation, this could become effective in raising total revenue despite exemption of new investment. Further, even if there is a loss of revenue in the short run, the volume of savings which can be raised through government bonds is increased.

Economic inequalities are fostered by inequalities of income permitting inequalities of current consumption and in the long run inequalities of wealth. This leads to concentration of wealth and power. Wealth taxation, including death duties, can be used to counter these inequalities.

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<sup>17</sup>Chelliah, p. 71

<sup>18</sup>Ibid., p. 73.

<sup>19</sup>Ibid., p. 79.

Heavy taxation of income retards capital formation. High progressive taxation tries to cut consumption and accumulation immediately to the detriment of incentives.<sup>20</sup> Taxes on wealth are justified but an expenditure tax is on shaky ground.<sup>21</sup>

Expenditure or "spendings" taxes are not novel ideas. Irving Fisher credits Ogden Mills with the first workable idea of a spendings tax bill.<sup>22</sup> Fisher thought that income should properly be taxed on the basis of amounts spent with income saved not taxed at all. This he felt would place the tax on "real income" and remove the hobble from business which results from income taxes falling on savings. He charged that income taxes were: (1) unfair since they tax both saving and its fruits, (2) they provide incentives to dissave, (3) they are unwise, they depress the revenue which they ought to produce, (4) they are costly to enforce, and (5) they are vexatious to the taxpayer since his liability may be adjusted for several years after the taxable period.

Under the spendings tax as proposed gross receipts from all sources would be added together. Deductions would be granted for investments, taxes paid during the taxable

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<sup>20</sup>J. B. Ranga and N. A. Palkhivala, The Law and Practice of Income Tax (Bombay: N. M. Tripathi, 1963), p. xiii.

<sup>21</sup>Chelliah, p. 84.

<sup>22</sup>Irving Fisher, Constructive Income Taxation, pp. i-ix.

year, plus exemptions for the taxpayer and his dependents. The remainder would be his spendings and subject to tax.<sup>23</sup> The tax has been considered desirable by several writers but the record keeping required seems to have been so formidable an obstacle that they did not pursue it.

Kaldor used the same case in proposing an expenditure tax for India. He said that ordinary income taxation (1) fails to measure the real ability to pay of different taxpayers, (2) weakens the incentives to work, to save and bear risks and (3) is administratively unworkable since no comprehensive return is required.<sup>24</sup> All income, capital transactions and expenditures of the taxpayer must be reported on a single return to verify the taxpayer's reporting accuracy.

The expenditure tax, by encouraging saving and discouraging dissaving, should add to the flow of private saving. The economic considerations are counterbalanced by the arguments against the expenditure tax.

#### EXPENDITURE TAX

Of the taxes recommended by Higgins, the expenditure tax seems least likely to make an effective contribution

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<sup>23</sup> Ibid., pp. 3-17.

<sup>24</sup> Kaldor, An Expenditure Tax, pp. 10, 30-36.

toward the goals set. The limited use which has been made of expenditure taxes has not contributed to any great feeling of confidence and a host of arguments against their use have been marshalled:

- (1) Complexity of administration. The tax department probably does not possess either the personnel or the expertise to administer such a tax in addition to the normal administrative workload.
- (2) Blanket favorable treatment of savings. Productive investment is the goal not simply an increase in saving which probably would flow into traditional non-productive investment patterns.
- (3) The number of individuals subject to the tax is too small to affect total spending behavior in the economy. The tax as applied to India in 1958-59 is estimated to have affected about 6,000 taxpayers of about 600,000 individuals who were required to file income tax returns.
- (4) It is based on spending power exercised, not spending power possessed, and so comes no closer to measuring ability to pay than a conventional income tax.

- (5) Bases for the computation of an income tax and an expenditure tax present problems when both are present in the same tax system. Accruals used in income tax computation have to be converted to units of spending power for expenditure tax computation. As long as one tax is not completely replaced with the other, the problem will exist.<sup>25</sup>

The basic premise of the expenditure tax, that ability to pay is more accurately measured by spending than by income, has been questioned, as well as the effectiveness of the tax as a device for encouraging saving by the wealthy.<sup>26</sup> The conclusion which follows this argument is that a range of monetary devices will be most effective in mobilizing domestic saving.<sup>27</sup> Despite the arguments against it and the unfavorable results of the experiences of India and Ceylon, the expenditure tax may be useful in special cases where control of luxury spending is especially critical. The ineffectiveness of the tax as enacted by India and Ceylon may be traced to the erosion of its base by a myriad of exemptions and special allowances which curb its effect with respect to consumer durables.

<sup>25</sup> Chelliah, pp. 132-35.

<sup>26</sup> Hicks, p. 106.

<sup>27</sup> Ibid., pp. 37, 60, 107.

Selective monetary controls are an alternative to the over-all control which an expenditure tax would exercise over spending behavior. A progressive income tax with provisions for investment credit offers a straightforward approach to drawing saving into critical development projects.

The expenditure tax does not appear to be essential to the successful implementation of the Higgins system. Whatever is gained by its inclusion to make a perfectly closed system is lost by the increase in administrative unwieldiness. Vigorous enforcement would probably accomplish all that is sought in making the system effective and as already stated, investment could be channeled by manipulating the regular income tax.

Fisher recommended the complete replacement of income taxes while Kaldor recommended that income taxes be supplemented with an expenditure tax. An alternative to both positions is a progressive income tax with investment credit provisions. This would fill the role designed for the expenditure tax and lessen the problems of control. The dual basis for tax computation would no longer be necessary.

The Higgins model appears to be a step forward in tax planning and it should prove instructive as a guide for revising any tax system where economic development is a serious objective of policy. His greatest contribution is a comprehensive approach to the problem.

The administrative detail of his proposals do not appear to be insurmountable and the experience of India indicates what can be achieved with a tax system similar to that which Higgins has outlined.

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