

10th Social Science Lesson 18 Notes in English

18. Government and Taxes

Introduction

- Tax is levied by government for the development of the state's economy. The revenue of the government depends upon **direct and indirect taxes**.
- Direct taxes are levied on income of the persons and the indirect taxes are levied on goods and services by which the government mobilises its "**financial resources**".

Role of Government in Development Policies

The role of government and development policies

In India, the three levels of governments, namely, **union, state and local**, have been carrying out various functions for the benefit of people and society at large. These roles are into divided into seven categories for easy understanding.

Defence:

This is an essential security function to protect our nation from our enemies. We know that we have three services, namely, **army, navy and air force**. The Union government is responsible for creating and maintaining defence forces.

Foreign policy:

In today's world, we need to maintain friendly relationships with all the other countries in the world. India is committed to world peace. We should also maintain **cordial economic relationships through exports and imports**, sending and receiving investments and labour. This service is also provided by the Union government.

Conduct of periodic elections:

- India is a democratic country. We elect our representatives to Parliament and state assemblies.
- The Union government creates laws and administrative system and conducts elections to these two legislature institutions. Similarly the state governments conduct elections to local bodies within the state.

Law and order:

- Both the Union and state governments enact numerous laws to protect our rights, properties and to regulate our economy and society.

- To settle disputes, the Union government has a vibrant judicial system consisting of courts at the **national, state and lower levels and state governments** take the responsibility for administering the police force in respective states.

Public administration and provision of public goods:

- The government generally administers the economy and society through various departments, for example, revenue department, schools, hospitals, rural development and urban development.
- The list of departments with the Union and state governments are available in the public domain. The local governments provide public goods like **local roads, drainage, drinking water and waste collection and disposal**.

Redistribution of income and poverty alleviation:

- Governments collect various taxes to finance the various activities mentioned earlier.
- The taxes are collected in a way that the high-income people can bring in more tax revenue to the government than the poor.
- The governments also spend money such that the poor are given some basic necessities of life like **food, shelter, clothing education, health care and monthly income to the very poor persons**.
- Thus collecting taxes and spending for the poor is how the government redistributes income and introduces measures to reduce poverty.

Regulate the economy:

- The Union government, through the Reserve Bank of India, controls money supply and controls the interest rate, inflation and foreign exchange rate.
- The main objective is to remove too much of fluctuation in these rates.
- The Union also controls the economy through various other agencies such as **Securities Exchange Board of India and Competition Commission of India** All the governments in India run public sector enterprises to provide important goods and services at affordable rates to the people.

Tax

- The origin of the word "**tax**" is from "**taxation**," which means an **estimate**. Taxation is a means by which governments finance their expenditure by imposing charges on citizens and corporate entities.
- The main purpose of taxation is to accumulate funds for the functioning of the government machinery.
- Tax has come into forefront on account of the new concept of "**welfare state**". Modern governments do not confine themselves to law and order only.

- The importance of public finance (tax) has vastly increased in recent years. Taxes are compulsory payments to government without expectation of direct return (or) benefit to the tax payer.
- Prof. Seligman also defined a tax as **“a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred.”**

Why Taxes?

- The levying of taxes aims to raise revenue to fund governance or to alter prices in order to affect demand. States and their functional equivalents throughout history have used money provided by taxation to carry out many functions.
- Some of these include expenditures on economic infrastructure (**transportation, sanitation, public safety, education, healthcare systems, to name a few**), military, scientific research, culture and the arts, public works and public insurance and the operation of government itself.
- A government's ability to raise taxes is called its fiscal capacity. When expenditures exceed tax revenue, a government accumulates debt. A portion of taxes may be used to service past debts.
- Governments also use taxes to fund welfare and public services. These services can include education systems, pensions for the elderly, unemployment benefits and public transportation.
- **Energy, water and waste management systems are also common public utilities.** According to the proponents of the theory of money creation, taxes are not needed for government revenue, as long as the government in question is able to issue fiat money.
- The purpose of taxation is to maintain the stability of the currency, express public policy regarding the distribution of wealth, subsidising certain industries or population groups or isolating the costs of certain benefits such as highways or social security.

Tax system

- Every type of tax has some advantages and some disadvantages. So we have a tax system, that is, a collection of variety of taxes.
- All countries use a variety of taxes. There are some characteristics of tax system that economists think should be followed while designing a tax system.
- These characteristics are called as canons of taxation. From **Adam Smith**, many economists have given lists of canons of taxation. It is important to recall those common among them for discussion here.

Canon of equity

- Since tax is a compulsory payment, all economists agree that equity is the cardinal principle in designing the tax system.
- The equity principal says that the rich should pay more tax revenue to government than the poor, because rich has more ability than the poor to pay the tax.
- Moreover, after payment of tax, you will find the economic difference is reduced between the rich and the poor.
- You can do an exercise to find out which of the taxes adhere to the canon of equity.

Canon of Certainty

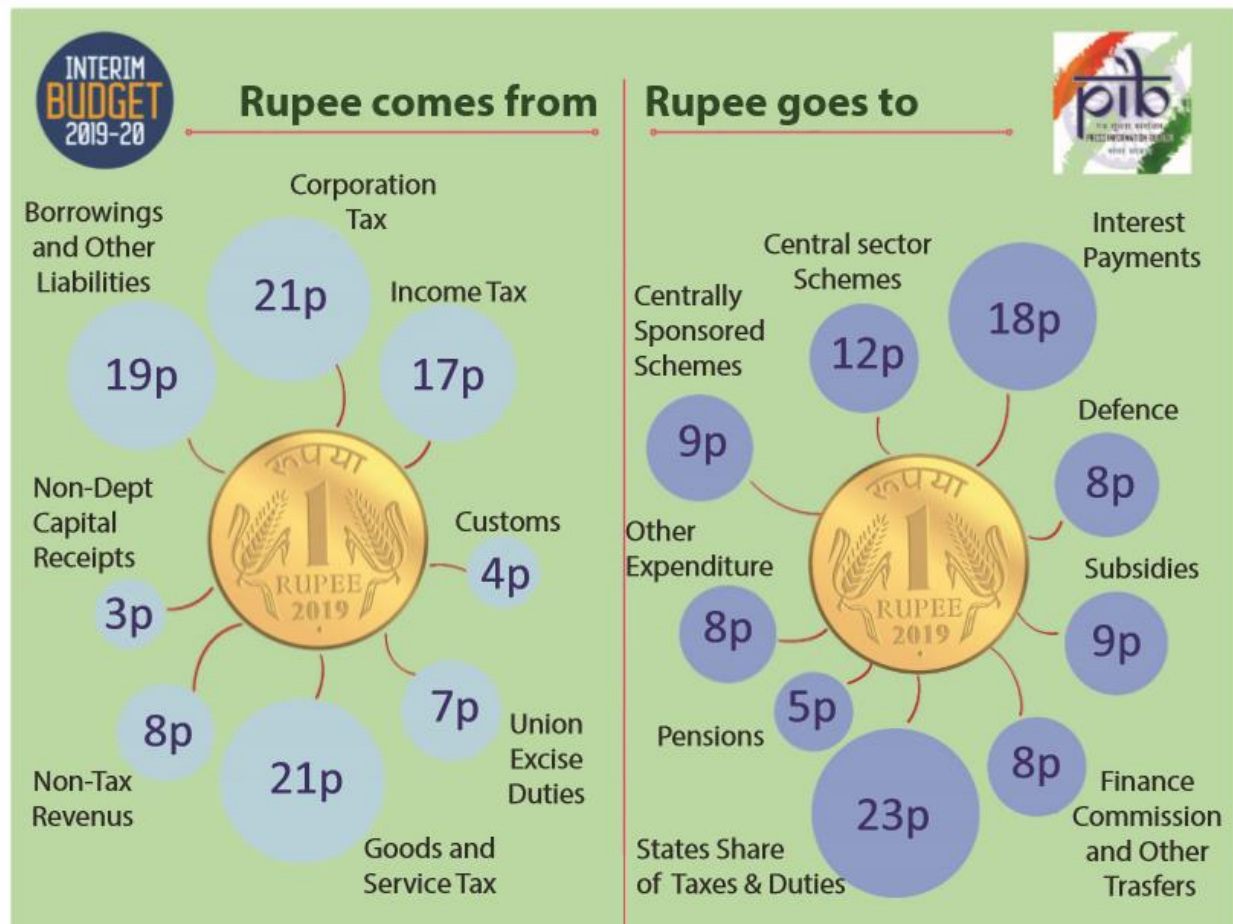
- Government should announce in advance the tax system so that every tax payer will be able to calculate how much tax amount one may have to pay during a year to the government.
- In other words, government should not change the tax system frequently and should not announce sudden changes in the tax system.

Canons of Economy and Convenience

- These two canons are related. As tax payers we incur a cost to process our accounts and pay the tax, for example, salary paid to accountants and auditors. Similarly government also pays salary to its taxmen and run huge institutions.
- If the tax is simple, then the cost of collecting taxes (**tax payer cost + tax collector cost**) will be very low.
- Further, tax should be collected from a person at the time he gets enough money to pay the tax. This is called canon of convenience. A convenient tax reduces the cost of collecting tax.

Canons of Productivity and Elasticity

- Government should choose the taxes that can get enough tax revenue to it. In other words, it should choose a few taxes that can fetch more tax revenue, instead of lots of taxes and each one of them getting a little tax revenue.
- This is canon of productivity. Tax is paid by the people out their incomes.
- Therefore the tax system should be designed in such a way that the people automatically pay more tax revenue if their incomes grow. This is called canon of elasticity. In a broader sense, as the economy is growing the people will get more income and consequently they will also pay more tax revenue to government if the tax system is elastic.



Types of Taxes

Direct Taxes

A tax imposed on an individual or organisation, which is paid directly, is a direct tax. The burden of a direct tax cannot be shifted to others. **J.S. Mill** defines a direct tax as **“one which is demanded from the very persons who it is intended or desired should pay it.”** Some direct taxes are income tax, wealth tax and corporation tax.

Income tax

Income tax is the most common and most important tax levied on an individual in India. It is charged directly based on the income of a person. The rate at which it is charged varies, depending on the level of income.

Corporate tax

Income	For Indian Companies	For Foreign Companies
Less than ₹ 50 crore	25%	40%
More than ₹ 50 crore	30%	40%

This tax is levied on companies that exist as separate entities from their shareholders. It is charged on royalties, interest gains from sale of capital assets located in India and fees for a technical services and dividends. Foreign companies are taxed on income that arises or is deemed to arise in India.

Wealth tax

Wealth tax is charged on the benefits derived from property ownership. The same property will be taxed every year on its current market value. The tax is levied on the individuals and companies alike.

Indirect Taxes

If the burden of the tax can be shifted to others, it is an indirect tax. The impact is on one person while the incidence is on the another person. Therefore, in the case of indirect taxes, the tax payer is not the tax bearer. Some indirect taxes are **stamp duty, entertainment tax, excise duty and goods and service tax (GST)**.

Stamp duty

Stamp duty is a tax that is paid on official documents like marriage registration or documents related to a property and in some contractual agreements.

Entertainment tax

Entertainment tax is a duty that is charged by the government on any source of entertainment provided. This tax can be charged on **movie tickets, tickets to amusement parks, exhibitions and even sports events**.

Excise duty

An excise tax is any duty on manufactured goods levied at the movement of manufacture, rather than at sale. Excise is typically imposed in addition to an indirect tax such as a sales tax.

Goods and service tax (GST)

- The goods and service tax (GST) is one of the indirect taxes. The GST was passed in Parliament on **29 March 2017**. **The act came into effect on 1 July 2017**.
- The motto is **one nation, one market, one tax**. Goods and service tax is defined as the tax levied when a consumer buys a good or service.
- That aims to replace all indirect taxes levied on goods and services by the Central and state governments.
- GST would eliminate the cascading effect of taxes on the production and distribution of goods and services. It is also a **"one-point tax"** unlike value-added tax (VAT), which was a multipoint tax.

How Taxes Are Levied?

Tax is levied by the government progressively, proportionately as well as regressively

Progressive tax

Example:

Tax Base	Tax Rate	Amount of Tax
₹10,000	10%	₹1000
₹20,000	15%	₹3000
₹30,000	25%	₹7500
₹40,000	40%	₹16000

Progressive tax rate is one in which the rate of taxation increases (multiplier) as the tax base increases (multiplicand). The amount of tax payable is calculated by multiplying the tax base with the tax rate. In the case of a progressive tax, the multiplicand (income) increases. When income increases, the tax rate also increases. This is known as a progressive tax

Proportionate taxes

Example:

Tax Base	Tax Rate	Amount of Tax
₹10,000	10%	₹1000
₹20,000	10%	₹2000
₹30,000	10%	₹3000
₹40,000	10%	₹4000

Tax levied on goods and service in a fixed portion is known as proportionate taxes. All tax payers contribute the same proportion of their incomes. In this method, the rate of taxation is the same regardless of the size of income. The tax amount realised varies in the same proportions that of income.

Regressive Taxes

Progressive Tax	Income increase	Tax also Increase	E.g. Income Tax
Proportional Tax	Income Increase	Tax Decrease	E.g. Corporate Tax
Regressive Tax	Income change	Same tax always	E.g. Sales Tax

It implies that higher the rate of tax lower the income groups than in the case of higher income groups. It is a very opposite of progressive taxation.

Black Money

Black money is funds earned on the black market on which income and other taxes have not been paid. The unaccounted money that is concealed from the tax administrator is called black money.

Causes of Black Money

Several sources of black money are identified as causes.

1. Shortage of goods:

Shortage of goods, whether natural or artificial, is the root cause of black money. Controls are often introduced to check black money.

2. Licensing proceeding:

It is firmly believed that the system of controls permits, quotas and licences are associated with mal distribution of commodities in short supply, which results in the generation of black money

3. Contribution of the industrial sector:

Industrial sector has been the major contributor to **black money**. For example, the Controller of Public Limited Companies tries to buy commodities at low prices and get them billed at high amounts and pockets the difference personally.

4. Smuggling:

Smuggling is one of the major sources of black money. When India had rigid system of exchange controls, precious metals like **gold and silver, textiles and electronics goods** were levied a heavy excise duty. Bringing these goods by evading the authorities is smuggling.

5. Tax structure:

When the tax rate is high, more black money is generated.

Tax Evasion

- Tax evasion is the illegal evasion of taxes by individuals, corporations and trusts.
- Tax evasion often entails taxpayers deliberately misrepresenting the true state of their affairs to the tax authorities to reduce their tax liability and includes dishonest tax reporting, such as declaring less income, profits or gains than the amounts actually earned, or overstating deductions.
- Tax evasion is an activity commonly associated with the informal economy.
- One measure of the extent of tax evasion is the amount of unreported income, which is the difference between the amount of income that should be reported to the tax authorities and the actual amount reported. Tax evasion activities included
 1. Underreporting income
 2. Inflating deductions or expenses
 3. Hiding money
 4. Hiding interest in offshore accounts

Causes of tax evasion

- Tax evasion resulting in black money prevents the resource mobilisation efforts of the Union government. Shortage of funds distorts implementation of developmental plans and forces the government to resort to deficit financing in case public expenditure is inelastic.

- Tax evasion interferes with the declared economic policies of the government by distorting saving and investment patterns and availability of resources for various sectors of the economy.
- Tax evasion undermines the equity attribute of the tax system. Honest taxpayers willingly bear disproportionate tax burden, feel demoralised and lured to join the tax evaders' camp.
- Tax evasion and black money encourage the concentration of economic power in the hands of undeserving groups in the country, which, in turn, is a threatening to the economy in its way.
- Evasion of tax consumes time and energy of tax administration to disentangle the intricate manipulations of tax dodgers.

Tax evasion penalties

- If a person will fully commits the act of tax evasion, he may face felony charges. Tax evasion penalties include imprisonment of up to five years and high amount as fines.
- The defendant may also be ordered to pay for the costs of prosecution
- Other tax evasion penalties include community service, probation and restitution depending on the circumstances of the case
- Tax evasion penalties can be harsh, depending on the severity of the crime.

Tax and other Payments

S. No.	Tax	Payments
1	Tax is compulsory to the government without getting any direct benefits	Fee is the payment for getting any service
2	If the element of revenue for general purpose of the state predominates, the levy becomes a tax	While a fee is a payment for a specific benefit privilege although the special to the primary purpose of regulation in public interest.
3	Tax is a compulsory payment	Fee is a voluntary payment.
4	If tax is imposed on a person, he has to pay it; otherwise he has to be penalised	On the other hand fee is not paid if the person do not want to get the service
5	In this case, tax payer does not expect any direct benefit. Example: Income tax, gift box, wealth tax, VAT etc.	Fee payer can get direct benefit for paying fee. Examples: stamp fee, driving license fee, government registration fee

Taxes are compulsory payments to government without expectation of direct return (or) benefit to the tax payer. Payment includes income received from production and supply of goods and services of public enterprises and revenue from administrative activities. Payments from nontax sources other than tax income is known as payments. Some payments are fees, fines and penalties, and forfeitures.

Taxes and Development

The role of taxation in developing economics is as follows.

1. Resource mobilisation:

Taxation enables the government to mobilise a substantial amount of revenue. The tax revenue is generated by imposing direct taxes such as personal income tax and corporate tax and indirect taxes such as **customs duty, excise duty, etc.**

2. Reduction in inequalities of income:

Taxation follows the principle of equity. The direct taxes are progressive in nature. Also certain indirect **taxes, such as taxes on luxury goods**, is also progressive in nature.

3. Social welfare:

Taxation generates social welfare. Social welfare is generated due to higher taxes on certain undesirable products like alcoholic products.

4. Foreign exchange:

Taxation encourages exports and restricts imports, Generally developing countries and even the developed countries do not impose taxes on export items.

5. Regional development:

Taxation plays an important role in regional development, **Tax incentives such as tax holidays** for setting up industries in backward regions, which induces business firms to set up industries in such regions.

6. Control of inflation:

Taxation can be used as an instrument for controlling inflation. Through taxation the government can control inflation by reducing the tax on the commodities.

More to Know:

1. Recent Legislative Initiatives to curb Black Money in India

1. Constitution of the Special Investigation Team (SIT) on Black Money under Chairmanship and Vice-Chairmanship of two former Judges of Hon'ble Supreme Court.
2. Enactment of a comprehensive law – The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015.

3. Constitution of Multi-Agency Group (MAG) consisting of officers of Central Board of Direct Taxes (CBDT), Reserve Bank of India (RBI), Enforcement Directorate (ED) and Financial Intelligence Unit (FIU) for the investigation of recent revelations in Panama paper leaks.
4. Double Taxation Avoidance Agreements (DTAAs)/Tax Information Exchange Agreements (TIEAs)/Multilateral Conventions.
5. Foreign Account Tax Compliance Act (FATCA).
6. Money-laundering Act, 2002 through the Finance Act, 2015.
7. Enactment of the Benami Transactions (Prohibition) Amendment Act, 2016 .
8. Launching of 'Operation Clean Money' on 31 January 2017.
9. Lokpal and Lokayukta act.
10. The Real Estate (Regulation and Development) Act, 2016.

2. Structure of Goods and Service Tax (GST)

State Goods and Service Tax (SGST):

Intra state (within the state) VAT/sales tax, purchase tax, entertainment tax, luxury tax, lottery tax and state surcharge and cesses

Central Goods and Service Tax (CGST):

Intra state (within the state) Central Excise Duty , service tax, countervailing duty, additional duty of customs, surcharge, education and secondary/higher secondary cess

Integrated Goods and Service Tax (IGST):

Inter state (integrated GST) There are four major GST rates: **5%, 12%, 18% and 28%**. Almost all the necessities of life like vegetables and food grains are exempted from this tax.

3. France was the first country to implement GST in **1954** and many other European countries introduced GST in 1970-80.

4. In India taxes are collected by all the three tiers of government. There are taxes that can be easily collected by the Union government. In India almost all the direct taxes are collected by the Union governments. Taxes on goods and services are collected by both Union and state governments. The taxes on properties are collected by local governments. In India we collect more tax revenue through indirect taxes than through direct taxes. The major indirect taxes in India are customs duty and GST. Both these taxes have different tax rates for different goods and services. The governments try to design in such a way that the rich consumers pay more tax than the poor.

However, poor still pay more through these taxes. Therefore, many argue we should reduce the indirect taxes and increase the collection through direct taxes. Indian tax system adheres to all the canons of taxation. But there are arguments that often the equity principle is compromised and productivity is lost when we tinker with tax system to the advantage of a few. We announce the tax system once in a year in the annual budget. It is very rarely breached by announcing mid-year tax changes. Therefore, Indian tax system adheres to canon of certainty more than anything else.

5. In India, Income Tax was introduced for the first time **in 1860 by Sir James Wilson** in order to meet the losses sustained by the Government on account of the Mutiny of **1857**.

6. Taxation in India has its roots from the period of **Manu Smriti and Arthashastra**. The present Indian tax system is based on this ancient tax system.