Taxation Proposals of the Government

INTRODUCTION

"THE Government is fully conscious that an efficient and equitable system of personal taxation is fundamental to a fair and just society.... My (Finance Minister's) aim, therefore, is to cast the tax net more effectively, more realistically and more equitably by bringing the taxes levied on individuals into a far closer relationship with capacity to pay..... With these objectives in view, I propose certain changes in taxation which will result in the creation of an integrated, equitable and efficient machinery of direct taxation."[1] The new proposals have, therefore, been introduced with four main objectives in view: (i) the equitable distribution of the tax burden according to the capacity to pay, (ii) the closing of the existing avenues of escape, (iii) the procurement of maximum revenue that can be equitably collected and (iv) the increased efficiency of tax administration.

" The direct taxes, as they exist at present, fall on too narrow a base as the capacity to pay is measured by a restricted definition of 'income,' which is further narrowed down by an overgenerous treatment of expenses which are allowed as a deduction from profits[2]." Are we then not entitled to an explanation from the Minister of Finance why a better definition of income was not attempted and why income so defined as to include all capital gains and with weighting through time to eliminate undue fluctuations from year to year,[3] would not have been a better alternative to the proposed 'patchwork' system.

We are agreed with the Finance Minister that the burden of taxation at present falls more heavily on work than on property, " as many classes of gains, which arise not from effort and work, but are the direct result of the economic advantage a property-owner has over a fellow tax payer without property, now go untaxed under the existing system of taxation."[4] But while the inclusion of capital gains remedies to some extent this discrimination against income from work, the disallowance of the hitherto

1. Hansard, 17th July 1958 (uncorrected) : Budget Speech '58—'59. cc. 1184—1186.
2. Ibidem—c. 1184.
3. Vickrey, William—' Expenditure, Capital Gains and the Basis of Progressive Taxation in the Manchester School of Economic and Social Studies, Vol. XXV, No. 1, January, 1957.
4. Hansard—op. cit. c. 1185.

allowed earned income relief introduces an element of discrimination against income from work, and this will affect particularly the incentive for productive work, which in my opinion, in the context of our economy, must be promoted.

The Finance Minister argues that the Government has not been getting as much revenue, as it should, by taxing income, on account of the far too many exemptions, allowances, deductions and other opportunities such as artificial division of property or business income between members of a single family, illegitimate evasion and legal avoidance.[5] Have the proposed system remedied these ? Have the opportunities for evasion been reduced by the new taxes ? Such are the questions to which we must seek answers in examining the new taxation proposals.

" The high marginal rate becomes fictitious and inoperative on account of the various avenues of escape..... The evasion at the higher brackets is so easy and so great that the actual revenue collected at these levels is very small."[6] After making this admission of the inefficiency of the present tax administration the Minister of Finance proposes to reduce evasion at high income brackets by reducing the marginal rate of taxation from 85 per cent to 60 per cent. But with the same breath he suggests that the non-residents' immunity from wealth, capital gains and expenditure taxes is offset by the fact that his income tax remains unaltered and renders him liable to the higher rates of tax now prevailing. Does the Finance Minister here assume that the foreigner is honest as compared with the Ceylonese and the former therefore does not resort to tax evasion ?

We are agreed that the capacity to pay cannot be adequately measured by taking into consideration only income. But does the incorporation of the new proposals ensure equity between one class of tax payers and another ?

As pointed out earlier, the mere reduction of the marginal rate from 85 to 60 per cent does not close the avenues of tax avoidance. On the contrary, the introduction of the expenditure tax in order to bring within the tax net the higher income brackets, introduces many other avenues of escape. Disallowance of the earned income relief introduces discrimination against income from work. Taxing of all incomes (income inclusive of capital gains) as they are earned and taxing them when they are spent (under the expenditure tax) or saved (under the wealth tax) or

5. Ibidem—c. 1185.
6. Ibidem—c. 1185.

gifted (the gift tax or the estate duty) introduces another type of inequity between one class of tax payers and another, by taxing the same thing twice or more. Taxing of gifts in the hands of the donor (and not the donee), subjecting capital gains to a maximum marginal rate of 45 per cent as against 60 per cent on other income, also violates the very principle of equity, that the Finance Minister is trying to 'salvage' by his new tax proposals.

General Comments

I. The taxation proposals of the Finance Minister are based on the recommendations of Kaldor, which are nothing but a replica of his reforms of Indian taxation.[7] There are, however, a few important differences with regard to detail. (1) The gift tax, according to the Report on Indian Tax Reform, is to be levied on the recipients, increasing progressively with their total taxable capacity. But in Ceylon it would be levied on the donor, and goes against the very principle of equity that the Finance Minister is trying to uphold. Whether this error is a result of a misunderstanding of Kaldor by the Finance Minister or a slip on the part of Kaldor himself is yet to be ascertained. If the idea of the gift tax on the donor is to discourage dissipation of fortunes before death, then why have a tax on net wealth ? (2) According to the Indian Tax Reform, marginal rates should have been reduced to 45 per cent. Following perhaps the Indian adaptation of Kaldor's proposals the Finance Minister has fixed the maximum marginal rate at 60 per cent. (3) Kaldor has apparently suggested that capital gains (aggregated with other incomes) should not be taxed at more than 45 per cent because of his recommendation of a maximum marginal rate of 45 per cent on other income. The Finance Minister who perhaps may not have understood the implications of the above, announced that capital gains would not be taxed at more than 45 per cent, notwithstanding a maximum marginal rate of 60 per cent on other income. This is a violation of the principle of taxing according to taxable capacity, and also introduces an administrative problem.

II. Taxing 'ordinary' income plus capital gains when they are earned and taxing expenditure when they are spent would be taxing the same thing twice. On transfer an asset presumably not only attracts a new valuation for the Wealth Tax but also the Capital Gains Tax, and/or the Gift Tax if it were given away or passed at death.

7. Indian Tax Reform : Report of a Survey by Nicholas Kaldor. Delhi Department of Economic Affairs, Ministry of Finance, 1956.

III. The successful implementation of the new tax proposals inevitably depends on a comprehensive return furnished by the tax payer, and which must include (*a*) net wealth i.e., the change in totals over the year, (*b*) income return as at present, (*c*) gratuitous transfers (gifts made and received) (*d*) purchase and sale of capital assets during the year, (*e*) assets for personal use, (*f*) other capital and casual transactions, including sales and purchases of rights, leases and so on, as well as betting and other winnings, (*g*) and personal expenditure adjusted for exempted expenditure and for spreading-over of current and past purchases of durable consumer goods. The onus of providing the correct return rests with the tax payer. Can the tax administration and the tax payer reach that level of effeciency which is required for the successful implementation of the new proposals ?

IV. *Evasion* :—Are the incentives to evade, reduced under the new scheme ? Though the evasion of one tax is reduced due to the so called 'interlocking' of taxes,[8] outright evasion may yet be possible. Since under the proposed Expenditure Tax, chargeable expenditure must be ascertained on the basis of asset balances at the beginning and at the end of the period adjusted for income earned during the same period, evasion is bound to be as great as under an Income Tax. It may perhaps be more, since under an Expenditure Tax, expenditure can be concealed by spending on food and drink, and producing bogus medical bills. Mr Kaldor's self checking device would not work because the certificates of expenditure could be obtained from those who are below the taxable limit, or spending on the names of other people who escape expenditure tax, making gifts of less than Rs. 2,000/- every year, spending out of secret borrowing or by showing bogus loans in favour of people outside the tax orbit. PAYE system is possible under income tax, not under expenditure tax. Since gold and jewellery does not attract expenditure tax, (nor presumably a gift or a wealth tax) people may invest in them ; hoarding habits may increase, thereby impeding development.

V. *Administrative Difficulties* :—With regard to his Indian proposals Mr Kaldor himself admits that both the expenditure tax and tax on accrued incomes will be more difficult to administer than the present Income-surtax system, and emphasises that the Inland Revenue must be strengthened both in number and calibre of tax officers, and with higher pay ; but in the short period at least the supply of suitable officers is likely to be highly inelastic.[9] The situation is much more difficult in Ceylon. (1) Carry-forwards of capital losses under income tax make income tax returns

8. Hansard, op.cit. c. 1187.
9. Indian Tax Reform : op. cit.

more complicated. (2) What is there to prevent the negotiation of faked deeds, purchases, sales, borrowings, lendings, repayments etc. in collusion with people who are outside the purview of personal taxation? What means are available to the taxing authority for unearthing credit or even cash purchases on food and drink ? Will the retail stalls be licensed and made to keep a record of every petty transaction ? Will there be surprise inspections of retail shops and household effects ? (3) Capital gains may be concealed by manipulating on paper the price of assets sold. Purchasers would not mind if they are not within the taxable class. For example a block of 5 acres bought for Rs. 350,000 may be sold in 32 individual blocks of 25 perches each at Rs. 500/- per perch, capital gain therefrom being Rs. 50,000. To avoid payment of the tax, however, the price may be marked down to Rs. 437.50. The purchasers who have bought these blocks to build houses for owner occupation may not mind it. (4) Kaldor in his 'An Expenditure Tax' says "I do not believe, however, that, if a change-over to the expenditure basis of taxation were possible, there would be a sufficient case left for an annual tax on capital to surmount the serious administrative problems involved."[10] In Ceylon's case he may argue that the expenditure tax is only on those top income brackets (his case of surtax reform).[11] But then a tax on incomes inclusive of capital gains and a tax on expenditure beyond Rs. 35,000 per representative family, may be as effective as an income tax or an expenditure tax of the comprehensive type which Kaldor has in mind. Then where is the need for an annual wealth tax ?

VI. *Revenue Possibilities* :—The Minister assessed the revenue possibilities of his new proposals at Rs. 66 million, of which capital gains tax would contribute Rs. 25 million, wealth tax Rs. 20 million, expenditure tax Rs. 13 million and gifts tax Rs. 4 million. In India, Kaldor put the revenue from the capital gains tax between Rs. 25 to 40 crores, but the actual revenue per year was only Rs. 3 crores. Except in the realm of wild speculation, how can one estimate the revenue from capital gains tax without first ascertaining the values of all properties as at 1-4-58., and then making an assessment of the probable capital appreciation minus depreciation in one year. The revenue possibilities of the wealth tax can be assessed only after valuing all property within the taxable class. Revenue from expenditure tax can be estimated if the number of tax payers within the taxable class and their respective expenditures are known. Even if the present figures are known what is the guarantee that they will remain

10. Kaldor, Nicholas—An Expenditure Tax. Allen and Unwin Ltd. 1955, p. 90.
11. An Expenditure Tax : op. cit.

unaltered after the impact of the expenditure tax on this class of tax payers? It is not conceivable how the Minister of Finance could have assessed the revenue possibilities of these taxes at Rs. 66 million ; as good a guess as this could have been made by a man in the street.

VII. *Development* :—In an underdeveloped economy like Ceylon the tax system should be so designed as to promote economic development.

Even though the reduction of the marginal rate to 60 per cent may be an incentive for work, the impact of the expenditure tax, wealth tax, and gift tax taken together may discourage saving and thereby investment.

Insurance premia are exempt under the present income tax and policies on maturity do not become liable to tax either. Now, policies may be subject to wealth tax, and attract also a spendings tax when matured policies are used for expenditure. Some save for greater spending in the future; they may be discouraged by the expenditure tax. Some others save in order to make provision for their children ; they will be discouraged by the wealth tax and more by the gifts tax. Though savings may generally be discouraged hoarding may be encouraged ; people may invest more and more in gold and jewellery ; parents can provide for their children by investing in such non taxable items every year.

After making the above general comments on the taxation proposals, as a whole, let me now examine in detail each specific proposal. In the field of personal taxation, the Minister of Finance proposes to reform the existing system by including a tax on realized capital gains minus losses, a tax on net wealth, a tax on personal consumption expenditure and a tax on gifts, and by replacing the ' family allowance system ' by a quotient system ; in the field of company taxation, by substituting a uniform tax of 45% for the existing income plus profits tax system, and disallowing certain deductions for expenses hitherto allowed ; and in the field of indirect taxation certain minor changes.

I shall confine my remarks below only to personal and company taxation.

Review of Specific Proposals

Capital Gains Tax :—Under this tax, with effect from the year of assessment 1958—59, all capital gains minus losses, realized after the 1st April, 1957, (thereby retaining the previous year's basis, as under the existing income tax) will be taxed, subject to a maximum rate of 45%.

For tax purposes realization includes transfer under deed of gift, liquidation of a business, transmission on death or transfer to a trust. Carry-forward of losses is allowed indefinitely ; if a person's estate shows unabsorbed losses at death, the taxes which could have been reclaimable as losses will be credited against estate duty; unrealized capital gains at death will be added to the income of the deceased for the last assessment year.

In the case of tax payers who had no taxable income in the three previous years, capital gains upto Rs. 5,000, would be exempt ; capital gains on movable property, other than stocks or shares will only be charged if the gains exceed Rs. 2,000 in any one year.

The immediate impact of this tax may be largely psychological. Lower prices may now have to be quoted in order to induce the would-be-buyers to invest in shares. Others may sell now, expecting share prices to fall in the future. Overall effect of these would be to depress the share market. Those investors who have hitherto been investing more for capital appreciation than for an annual net yield, may now shift into safe investments with an assured net income ; risk bearing may thus be discouraged.

The tax as applied to Ceylon, can also be criticised on a number of other grounds :—

(1) There is no justification on equity grounds to subject capital gains to a maximum rate of 45% when other incomes are liable to a maximum limit of 60%. This may also create administrative difficulties.

(2) A tax on capital gains on transference at death may lead to double taxation, since they may attract estate duty also.

(3) There is ' a-priori ' reason to think that easily traceable gains such as those on the Stock Exchange would be a much smaller part of total gains in Ceylon ; share market in Ceylon is both a restrictive and (mainly) an investment market. The advantages of a capital gains tax in Ceylon compared with the opportunity costs of administering the tax seems, therefore, very problematical.

Wealth Tax :—Net value of all property aggregated will be liable to this tax. Net worth upto Rs. 100,000, however, is exempt with an ½% tax on the next Rs. 400,000, 1% tax on the next Rs. 500,000 and 2% tax on anything above. The appointed date for the tax is 1-4-57 and the tax is due from the current year of assessment, on the previous year's basis. The responsibility for the initial valuation of all property rests with the tax payer.

The tax can be criticised on three main grounds :—

(1) According to the provision made, the onus of valuing his property and furnishing a correct return rests with the tax payer. This is asking too much from the Ceylonese tax payer and may raise considerable administrative difficulty for the Tax Department. (2) Under the so called 'interlocking' system, though evasion through under-valuation or over-valuation may not be resorted to, outright evasion through non-declaration may yet be possible. Property may be overvalued if the avoidance of capital gains tax leaves the taxpayer with a smaller tax burden. (3) Lastly, to my mind, there does not seem any necessity for continuing the present Estate Duty also, along with the proposed Gifts and Wealth taxes.

Expenditure Tax :—This is a tax on personal consumption expenditure. In order to assess the net chargeable expenditure, the following deductions are made from the total expenditure : (i) business expenses, (ii) investment outlays, (iii) capital investment for personal use such as the purchase of a dwelling house for owner occupation (except the net annual value which will be the same as for income tax purposes), (iv) gifts not exceeding Rs. 2,000 per year and (v) necessitous expenditure such as (*a*) direct taxes, (*b*) court fines and expenditure incurred in criminal proceedings, (*c*) funeral and birth expenses not exceeding Rs. 2,000 (*d*) marriage exenditure upto Rs. 3,000 (*e*) medical expenses upto a maximum of Rs 3,000 and (*f*) expenses upto a maximum of Rs. 8,000 incurred in education of children abroad ; expenditure on durable consumption goods like furniture, motor cars, and expenditure for foreign travel are spread over five years. The tax takes effect from the assessment year 1959—'60 and is based on the expenditure incurred in the preceding year.

Taxable expenditure includes gifts received in kind and expenses met by employer. Respectively, these are taxed in the form of a gifts tax on the donor and not allowed as (tax-free) expenses to the employer. This amounts to taxing the same thing twice, both at the giving and the receiving ends.

Retired persons, who live on past savings will be adversely discriminated. Their savings are net of tax, tax having been paid on gross savings; when these savings are spent, he is taxed again. Is it equitable ?

Possibilities of evasion may be greater under the proposed spendings tax. People may spend more on food and drink in order to evade the tax ; it may be inflationary if the import of foods is restricted in order to divert foreign exchange earnings to the import of capital equipment.

A period of five years has been arbitrarily chosen for spreading-over of durable consumer goods. The notional benefits derived from household equipment like a piano or a refrigerator, may, however, last much longer than five years.

The expenditure tax has apparently been proposed in order to curb extravagant expenditure and to stimulate capital formation.

If the idea of the expenditure tax is to promote capital formation, then why have a wealth tax, which may discourage savings and investment ? In this connection, it may be argued that the wealth tax may induce productive investment as against the possession of 'idle' wealth. Productive investment, however, is guided more by other considerations, such as the profitability relative to risk-bearing, anticipation of probable profits as compared with probable losses and the availability of funds for working capital. If a probability of profit is balanced by a probability of equal loss, then other things remaining the same, the investor may prefer to pay the tax on idle capital (i.e. uncultivated land) rather than undertake new risks.

Gifts Tax :—By this tax a levy is made on the donor for all gifts aggregated exceeding Rs. 2,000 per year. In computing the gifts tax, credit will be given for stamp duty paid on the deed of gift. The rates of gifts tax are as follows :—

Upto	Rs.	2,000	nil
Next	,,	50,000	5%
,,	,,	25,000	8%
,,	,,	25,000	10%
,,	,,	40,000	12%
,,	,,	40,000	13%
,,	,,	80,000	18%
,,	,,	80,000	20%
,,	,,	80,000	25%
,,	,,	80,000	30%
,,	,,	80,000	35%
,,	,,	80,000	45%
,,	,,	80,000	50%
,,	,,	250,000	60%
,,	,,	450,000	80%
on balance			100%

" In the calculation of estate duty, the estate duty on the whole estate (as if the gifts had not been made) will be computed and credit given for amount of gift tax paid. The present practice of not making a refund in a case where stamp duty credited against the estate duty exceeds the latter will apply in the case of gifts where stamp duty exceeds the gifts tax and in the case of an estate where the gifts tax to be credited against estate duty will result in a negative liability."[12]

The gifts tax comes into force in 1959—'60 and is applicable to gifts made after 1st April, 1958.

One strong criticism against this tax is that it is levied on the donor. This violates the very principle of equity, that the Finance Minister is trying to safeguard by the system of new taxes.

Quotient System :—The quotient system applies to both the Income Tax and the Expenditure Tax ; incomes and expenditures of family units are aggregated respectively for the two taxes and the tax liability is made to vary with the size of the family. Husband and wife are treated as one unit each ; each unmarried child under 25 as half a unit, excluding those above 21 and below 25 who run separate homes. The maximum number of units recognised for tax purposes is 4.

Under the income tax, each adult unit, (full unit) is given a tax-free allowance of Rs. 2,000, with the exception that a single person and a single person with a child or dependant, an extra allowance of Rs. 1,000 and Rs. 1,500 respectively ; the balance of the income of each unit will be charged on a slab system as follows :

on first Rs.	1,500	per each unit	5%
on next Rs.	1,500	,, ,, ,,	10%
,, ,,	1,500	,, ,, ,,	15%
,, ,,	1,500	,, ,, ,,	20%
,, ,,	1,500	,, ,, ,,	25%
,, ,,	1,500	,, ,, ,,	30%
,, ,,	1,500	,, ,, ,,	35%
,, ,,	1,500	,, ,, ,,	40%
,, ,,	3,000	,, ,, ,,	45%
,, ,,	3,000	,, ,, ,,	50%
,, ,,	3,000	,, ,, ,,	55%
the balance		,, ,, ,,	60%

12. Hansard (uncorrected version) 17th July 1958. Column 1203.

In dropping the Earned Income Relief, (along with the other family allowances existing under the old system), the Finance Minister said that the need for an Earned Income Relief disappears with the new tax structure he proposes, in which a wealth tax forms a necessary part.[13] In the new system, however, while the discrimination in favour of income from work as against income from property is abolished, a new discrimination is introduced, a discrimination against accumulation of property and not income from accumulated property.

Under the Expenditure Tax, on the other hand, each unit will be given a tax-free allowance of Rs. 8,000 in addition to a basic allowance of Rs. 3,000 for each family irrespective of the number of units. The maximum possible allowance is Rs. 35,000, and is given to a family of 4 units or more. The rates of tax for each unit are as follows :—

on the first Rs.	5,000	of expenditure after tax free allowance	20%
on the next Rs.	5,000		40%
,, ,,	5,000		80%
,, ,,	5,000		160%
on the balance			240%

Taxation of Business and Professional Incomes :—(1) The most radical change in the field of company taxation is the replacement of the existing dual tax on company profits (30% profits tax and 39% income tax on profits net of profits tax) by a uniform tax of 45%. The exact implications of the provision as regards non-resident companies are not very clear. 45% was chosen as the rate of tax because it was deemed to impose the same effective burden. Let me examine this. Under the old system a company paid a total tax of about 57.3%. The effective burden therefore would be the same under the two systems only on the assumption that the shareholders under the old system, got a tax refund of 12.3%. Without such an assumption, it is not possible to make the comparison.

(2) Initial allowances and annual depreciation allowances will be replaced by capital allowances of 33 1/3% on industrial buildings, 50% on durable plant and machinery, 66 2/3% on normal machinery and 80% on shortlived equipment. These allowances could be treated as relief only on the ground that the respective present discounted value of the future annual depreciation of these capital assets would be reduced to the respective percentages of capital allowances given above. If they are more, which is likely in view of the existing and future likely interest

13. Hansard (uncorrected) 17th January 1958. cc. 1193—1194.

rates, the capital allowances, at the beginning, would only amount to a deferment of a part of the tax liability. The development subsidy of 20% on capital expenditure newly incurred, on the other hand, is a total remission of a part of tax liability.

(3) Lastly, certain deductions for expenses, hitherto allowed, will be disallowed in the future. They are :—

(i) entertainment expenses of all kinds,
(ii) expense allowance given by a business to its executive staff,
(iii) travelling expenses of all kinds incurred in respect of the owner, partner, director or higher grade executive of a business (excepting the cost of passages abroad for the personal benefit of a director or an employee and his family), and
(iv) one half of the expenditure incurred on advertising.

No change seems to have been effected in single proprietorships and partnerships with respect to (iii) above. Sales promotion specially of new products, may be affected, particularly by (iv).

Conclusion :—Taking everything into account, new taxation proposals may not promote economic growth ; with regard to equity, will the inequities of the so called integrated system which may not work satisfactorily in practice be less than those of the existing system with its present standard of enforcement ? Avenues of tax escape and tax avoidance might, in all probability, increase. The net result will be that the purposes, for which the new proposals have been introduced, would be frustrated.

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