Tax System of India

What is tax?

Tax is a **compulsory payment** by the **individuals, household, firms or other institutional** units to the **Government** to meet public expenditure. It is legally imposed by Government and tax bearers cannot deny paying the same.

Purpose of Taxation

1. **Allocation of Resources :** When some industries are subjected to high taxes, resources from the high-taxed industries will be diverted to the low-taxed ones.
2. **Distribution of Income:** Its goal is to reduce inequities in income and wealth distribution to achieve the purpose of social fairness.
3. **Stabilization:** Taking on inflation, slowing down, and so forth (through appropriate fiscal policy). It contributes to the preservation of high employment and price stability.

Method of Taxation:

- **Progressive Taxation**: his method has increasing rates of tax for increasing value or volume on which the tax is being imposed. Indian income tax is a typical example of it. The idea here is less tax on the people who earn less and higher tax on the people who earn more—classifying income earners into different slabs. This method is believed to discourage more earnings by the individual to support low growth and development unintentionally. Being poor is rewarded while richness is punished. Tax payers also start evading tax by showing lower unreal income. But from different angles this tax is pro-poor and taxes people according to their affordability/sustainability. This is the most popular taxation method in the world and a populist one, too.
- **Regressive Tax**: This is just opposite to the progressive method having decreasing rates of tax for increasing value or volume on which the tax is being imposed. There are not any permanent or specific sectors for such taxes. As a provision of promotion, some sectors might be imposed with regressive taxes. As for example, to promote the growth and development of small scale industries, India at one time had regressive excise duty on their productions—with increasing slabs of volume they produced, the burden of tax used to go on decreasing. This method while appreciated for rewarding the higher producers or income-earners, is criticized for being more taxing on the poor and low-producers. This is not a popular mode of taxation and not as per the spirit of modern democracies.
- **Proportional Tax**: In such a taxation method, there is neither progression nor regression from the point of view rate of taxes point of view. Such taxes have fixed rates for every level of income or production, they are neutral from the poor or rich point view or from the point of view of the levels of production. Usually, this is not used by the economies as an independent method of taxation.

Types of taxes in India:

- **Direct Tax:** The tax which has incidence and impact both at the same point is the direct tax—the person who is hit, the same person bleeds. As for example income tax, interest tax, etc. Direct taxes are levied on corporate entities and individuals. These taxes cannot be transferred by the taxpayer to someone else. For individual taxpayers like you, the most important type of Direct tax is the income tax. This tax is levied during each assessment year (1st April to 31st March). As per the Income Tax Act, 1961, it is mandatory for you to make income tax payments if your annual income is above the minimum exemption limit. You can get tax benefits under various sections of the Act.
- **Indirect Taxes:** The tax which has incidence and impact at the different points is the indirect tax—the person who is hit does not bleed someone else's blood. As, for example, excise, sales tax, etc., are imposed on either the producers or the traders, but it is the general consumers who bear the burden of tax. Indirect tax is a tax that can be passed on to another individual or entity. Indirect tax is generally imposed on suppliers or manufacturers who pass it on to the final consumer. Excise duty, customs duty, and Value-Added Tax (VAT) are examples of Indirect taxes.

Types of Direct taxes in India

1. **Income Tax**: Depending on an individual's age and earnings, income tax must be paid. Various tax slabs are determined by the Government of India which determines the amount of Income Tax that must be paid. The taxpayer must file Income Tax Returns (ITR) on a yearly basis. Individuals may receive a refund or might have to pay a tax depending on their ITR. Huge penalties are levied in case individuals do not file ITR.

Comparison between FY 2023-24 & 2022-23 for New Tax Regime

Income Tax Rates	FY 2022-23 Income Tax Slab	FY 2023-24 Income Tax Slab
NIL	Rs.0 - Rs.2.5 lakh	Rs.0 - Rs.3 lakh
5%	Rs.2.5 lakh - Rs.5 lakh	Rs.3 lakh - Rs.6 lakh
10%	Rs.5 lakh - Rs.7.5 lakh	Rs.6 lakh - Rs.9 lakh
15%	Rs.7.5 lakh - Rs.10 lakh	Rs.9 lakh - Rs.12 lakh
20%	Rs.10 lakh - Rs.12.5 lakh	Rs.12 lakh - Rs.15 lakh
25%	Rs.12.5 lakh - Rs.15 lakh	–
30%	Above Rs. 15 lakhs	Above Rs. 15 lakh

Types of Direct taxes in India

- **Wealth Tax:** The tax must be paid on a yearly basis and depends on the ownership of properties and the market value of the property. In case an individual owns a property, wealth tax must be paid and does not depend on whether the property generates an income or not. Corporate taxpayers, Hindu Undivided Families (HUFs), and individuals must pay wealth tax depending on their residential status. Payment of wealth tax is exempt for assets like gold deposit bonds, stock holdings, house property, commercial property that have been rented for more than 300 days, and if the house property is owned for business and professional use.
- **Estate Tax:** It is also called as Inheritance Tax and is paid based on the value of the estate or the money that an individual has left after his/her death.
- **Corporate Tax:** Domestic companies, apart from shareholders, will have to pay corporate tax. Foreign corporations who make an income in India will also have to pay corporate tax. Income earned via selling assets, technical service fees, dividends, royalties, or interest that is based in India are taxable. The below-mentioned taxes are also included under Corporate Tax:
- **Capital Gain Tax:** It is a form of direct tax that is paid due to the income that is earned from the sale of assets or investments. Investments in farms, bonds, shares, businesses, art, and home come under capital assets. Based on its holding period, tax can be classified into long-term and short-term. Any assets, apart from securities, that are sold within 36 months from the time they were acquired come under short-term gains. Long-term assets are levied if any income is generated from the sale of properties that have been held for a duration of more than 36 months.

Advantages of Direct Taxes

- **Economic and Social balance:** The Government of India has launched well-balanced tax slabs depending on an individual's earnings and age. The tax slabs are also determined based on the economic situation of the country. Exemptions are also put in place so that all income inequalities are balanced out.
- **Productivity:** As there is a growth in the number of people who work and community, the returns from direct taxes also increases. Therefore, direct taxes are considered to be very productive.
- **Inflation is curbed:** Tax is increased by the government during inflation. The increase in taxes reduces the necessity for goods and services, which leads to inflation to compress.
- **Certainty:** Due to the presence of direct taxes, there is a sense of certainty from the government and the taxpayer. The amount that must be paid and the amount that must be collected is known by the taxpayer and the government, respectively.
- **Distribution of wealth is equal:** Higher taxes are charged by the government to the individuals or organisations that can afford them. This extra money is used to help the poor and lower societies in India.

Types of Indirect Taxes in India

1. **Service tax:** This tax is levied by an entity in return for the service provided by them. The service tax is collected by the Government of India and deposited with them.
2. **Excise duty:** When any product or good is manufactured by a company in India, then the tax levied on those goods is called the Excise Duty. The manufacturing company pays the tax on the goods and in turn recover the amount from their customers.
3. **Value Added Tax:** Also known as VAT, this type of tax is levied on any product sold directly to customer and are movable. VAT consists of Central Sales Tax which is paid to the Government of India State Central Sales Tax which is paid to the respective State Government.
4. **Custom Duty:** This a tax levied on the goods imported to India. Sometimes, Customs Duty is also levied on products which are exported out of India.
5. **Stamp Duty:** This is a tax levied on the transfer of any immovable property in a state of India. The state government in whose state the property is located charges this type of tax. Stamp tax is also applicable on all legal documents too.
6. **Entertainment Tax:** This tax is charged by the state government and is applicable on any products or transactions related to entertainment. Purchasing of any video games, movie shows, sports activities, arcades, amusement parks, etc. are some of the products on which Entertainment Tax is charged.
7. **Securities Transaction Tax:** This tax is levied during the trading of securities through Indian Stock Exchange.

Advantages of Indirect Tax

- **Convenience:** Indirect taxes do not burden the taxpayer and are convenient as they are paid only at the time of making a purchase. Moreover, state authorities find it convenient to levy indirect taxes because they are collected directly at the stores/factories which helps in saving a lot of time and effort.
- **Ease of collection:** Indirect taxes are easy to collect in comparison with direct taxes. Since indirect taxes are only collected at the time of making purchases, the authorities need not worry about their collection.
- **Collection from the poor:** Those who earn less than Rs.2.5 lakh p.a. are exempt from income tax, which means that they do not contribute to the government. Since indirect taxes are charged at the point of sale, all individuals, regardless of the income tax slab under which they fall, contribute towards the growth of the economy.
- **Equitable contributions:** Indirect taxes are directly related to the costs of products and services. What this essentially means that the basic necessities attract lower rates of tax while luxury items are charged at higher tax rates, thereby ensuring that contributions are equitable.

The Journey of GST in India:

- The journey of GST was started in the year 2000 when a committee was formed to draft the GST law by our former Prime Minister, Atal Bihari Vajpayee. It took 17 years for the government to evolve the law and then, the GST bill was passed by the Parliament in the year 2017. The Act finally came into effect from the 1st of July 2017.
- **The components of GST are as follows: Central Goods and Services Tax (CGST)** Applicable to the transactions done within state boundaries or at the intrastate level
- **State Goods and Services Tax (SGST)** Like CGST, this tax is also applicable to the transactions done within state boundaries or at the intrastate level
- **Integrated Goods and Services Tax (IGST)** Applicable to the transactions done between different states or at the interstate level.

Canons of Taxation

- By canons of taxation we simply mean the characteristics or qualities which a good tax system should possess. In fact, canons of taxation are related to the administrative part of a tax. Adam Smith first devised the principles or canons of taxation in 1776.
- Even in the 21st century, Smithian canons of taxation are applied by the modern governments while imposing and collecting taxes.
- **Types of Canon of taxation**
- In this sense, his canons of taxation are ‘classical’ in sense, four canons of taxation are:
- (i) Canon of equality or equity
- (ii) Canon of certainty
- (iii) Canon of economy
- (iv) Canon of convenience.
- Modern economists have added more in the list of canons of taxation, these are:
- (v) Canon of productivity
- (vi) Canon of elasticity
- (vii) Canon of simplicity
- (viii) Canon of diversity

Types of Canon of taxation

I. **Canon of Equality:** Canon of equality states that the burden of taxation must be distributed equally or equitably among the taxpayers. However, this sort of equality robs of justice because not all taxpayers have the same ability to pay taxes. • Rich people are capable of paying more taxes than poor people. Thus, justice demands that a person having greater ability to pay must pay large taxes.

II. **Canon of Certainty**: The tax which an individual has to pay should be certain and not arbitrary. According to A. Smith, the time of payment, the manner of payment, the quantity to be paid, i.e., tax liability, ought all to be clear and plain to the contributor and to everyone. Thus, canon of certainty embraces a lot of things. It must be certain to the taxpayer as well as to the tax-levying authority. Not only taxpayers should know when, where and how much taxes are to be paid. In other words, the certainty of liability must be known beforehand. Similarly, there must also be certainty of revenue that the government intends to collect over the given time period.

III. **Canon of Economy** This canon implies that the cost of collecting a tax should be as minimum as possible. Any tax that involves high administrative cost and unusual delay in assessment and high collection of taxes should be avoided altogether.

IV. **Canon of Convenience** Taxes should be levied and collected in such a manner that it provides the greatest convenience not only to the taxpayer but also to the government. Thus, it should be painless and trouble-free as far as practicable. “Every tax”, stresses A. Smith: “ought to be levied at time or the manner in which it is most likely to be convenient for the contributor to pay it.”

Tax to GDP Ratio

India has introduced far-reaching reforms in the domains of both direct and indirect taxes, it remains largely a tax non-compliant society as evident from the low tax-to-GDP ratio. Underperformance in tax revenue generation is not only due to paucity in tax policy reforms, but also due to slow pace of reforms in tax administration, ease of doing business and governance in general.

- **Reasons behind low tax-to-GDP ratio**
- • **Low tax base**: High exemption threshold in case of personal income taxes and convoluted system of exemptions, tax cuts, preferential tax rates, deferral of tax liabilities etc. in case of corporate taxes
- • **Tax evasion:** Tax evasion and corruption undermines the legitimacy of the State. It creates a belief among the citizens that the public resources are being wasted, reducing the willingness to pay.
- • **Weak tax administration,** particularly at sub-national level, as a consequence of lack of technical expertise and financial resources, poorly drafted laws and corruption.
- • **Structural issues** like untaxed agricultural sector, low financial literacy, large share of informal economy and large number of cash based transactions. **Implications of Tax-to-GDP ratio**
- • **Limited Fiscal Capacity:** Reduces the resources available to the government and puts a constraint on Government spending
- • **Reduces Government Accountability:** In tax-compliant societies, Govt is more accountable to citizens. So, there is a better provision of essential services to people
- • **Citizen Participation in Governance:** A citizen’s stake in ensuring accountability would be greater if he pays taxes.

Specimen Questions and Answers

1. Which model of GST has been chosen by India?
   - Ans: Canadian model of GST has been chosen by India
2. What kind of Tax is GST?
   - *Ans: GST* is an indirect Tax.
3. What is the name of apex body of Income Tax Department?
   - *Ans*: he name of apex body of Income Tax Department is CBDT.
4. What is meant by Tax Heaven?
   - Ans. A country which gives tax exemptions to the foreign citizens that there will be no tax on investing the money in their country.
5. Under which system of taxation, the *tax rate* diminishes as the taxable amount increases?
   - Ans. Under regressive tax system the *tax rate* diminishes as the taxable amount increases.