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Original Article

Tax and Its Impact on the Economic System: An Overview of the Tax System in India

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ABSTRACT

One of the main and essential issues in the developing countries is vast financial resources. Having vast financial resources with an efficient management in the economy ultimately leads to the development of the economy. Therefore, most companies are looking for certain activities which result in directing investment flow. In this regard, one of the most significant factors which plays an effective role in investment attractiveness is Tax policy although economists do not agree with this idea. Whereas some of them pay specific attention to tax incomes from firms, others believe in obtaining career and capital tax. Likewise, many people believe that applying taxes is against the principles of business and it could disturb the relations of the market. Many countries have gained good experiences in the field of achieving economic growth through particular financial policies. In this article an analytical-descriptive research method has been used to propose ways to contribute to developing the economy of the country. Additionally, the backgrounds of the relevant research studies, role of the tax and its effect on the economy will be studied and tax scenario of India which is essential for economic development of this country will be evaluated.

Keywords: Tax, India, Tax policy, direct and indirect taxes.

Introduction

In economics, tax consists of a part of income, wealth, sales or part of any other basic salary which is taken by the government from legal and natural individuals. The governments utilize tax systems for managing settlement flow and budget costs. Each government faces various options for the method of designing tax system in order to supply services and citizens' finances. Moreover, each country deals with challenges related to tax system and examples like increase of their own required income and distribution of what is gained and other goals in a way that economic decisions follow the least deviation.

The tax policy was always an important tool to increase income. Moreover, the tax policy is a significant tool to achieve a correct pattern for identification of sources, income distribution and economic stability with the goal of distributing profits of the economic development fairly (Hudson and Teera, 2004). The actual amount of the collected tax income depends on tax potential of each country and the government's ability in applying a method to collect tax (Eshag, 1983).

The tax and government are two of the most important factors of the most effective elements in all economic and social systems. Moreover, the tax has become inseparable factor of the governments after formation of the social governments and frameworks.

If the existence of the social government and system is necessary, conducting the relevant tasks has some costs that is necessary to find ways for supplying its financing costs. Tax is one of the best ways to supply costs in the ordinary economic conditions. In one hand, even the severe critics of the government, for instance, although Hayek (1994), Nozicks (1974), Friedman, and the groups of the general selections consider the government an evil, they insist there is no way but tolerating this evil. In spite of all difficulties of the government for any individual and group, as if this necessity has been regarded definite (Atkinson and Stiglitz, 1987). Apart from anarchists, other schools and authorities consider the existence of the government necessary for supervision of public affairs and controlling economic affairs. Forming an efficient tax system to supply costs of the public sector is a natural and logical necessity. In case of formation of the government and optimal tax, corruption will decrease and an efficient and significant link will be formed between private and governmental sectors. Therefore, the costs of the public sector will be supplied naturally and through standard function of the economy in the private sector.

Literature Review

The Government and Optimal Tax

The government and optimal tax are taken up based on the frameworks of economic theories of the public sector and finance. In theories of the public finance and economy of the old public sector, the government was always a benevolent entity and taxation was regarded as people's duty. It was assumed that the government would use tax for the general welfare (Pigou, 1920). In new theories, a kind of review was made on the nature of the government. So that the experience showed that in spite of taking tax, the government often does not make the welfare better, but also it sometimes gets worse. Some studies showed that a series of institutional dimensions besides the government and tax should be considered in order to make the authorities improve their official duties toward citizens (Buchanan, 1967). Knut Wicksell, the prominent Swedish economist who is of the spearheaded of the public finance, in the late twentieth century had made us aware of the early warnings in relation to the government and tax. He believed that the failure of the economists was that they were too concerned about behavior of the firms but they didn't pay any attention to the government's behavior, especially to the tax (1896, Wicksell). Later, Buchanan *et al.* studied seriously the extreme emphasis of the economists on dedication of sources and lack of their attention to the institutional affairs and following them, studies of social selection were formed which are included remarkable number of theories for the optimal government (1990, Buchanan). Formation of institutional economics expanded the necessity of the government process and optimized tax and administration. In the late 1990 and early twenty-first century, the developments related to good management and governance as basis of behavior modification in the public sector were emphasized. So, even subjects about modification of the principal institutions and laws of the countries in the second decade of the actual century were reviewed. From 1974 to 1987, about 80 constitutions were revised in various countries around the world under effect of the warnings and analysis in inefficiency of the public management and creation of cash packages and scientific survey, leading to reporting 160 cases at that time (Epstein, 2011)

One of the key factors to the optimal government is its formation from the correct paths along with democratic tools. Other factors are cost supply through tax and having a non-rentier framework and activity in the finite period. Primarily, the private sector and tax payers easily consider welfare effects resulting from tax realization on their own life in the optimal government. The economic activities in the private sector are so productive and profitable that adequate tax incomes are naturally gained from the economy cycle. As long as the government creates the standards of optimality, the tax system will develop; therefore, economic and tax corruptions will hold a remarkable share in the public sector and other economic sub-systems (Musgarve, 1984). There is no tax evasion in the optimal tax system or there is the least possible amount. On the other hand, in transparent tax systems, people make a kind of monitoring on the government performance and the tax exempts will be the least possible. Moreover, any exempt will be approved by professional study and adequate justification.

To date, regarding the studies related to the present investigation, it should be noted that research has dealt with tax systems of other countries such as England, Australia and Pakistan. Nonetheless, no comprehensive study has been done so far on the tax system of India. Since this country is successful both in the region and in the world in terms of the economy and in a short period of time since 1991, Manmohan Singh, current Finance Minister could ratify some programs in order to rescue the country from the bad economy and he could also supply the possibility of foreign investment and rapid economic growth by eliminating troublesome tax regulations in order to provide the country with the fourth largest economy in the world. Therefore, the tax system of India can offer us a path toward rapid economic development. The current inquiry accordingly intends to study the financial scenario of India.

Direct and Indirect Tax Incomes of the Central Government and States and Its Share of GDP

The tax structure of India is three-plied in which the constitution offers the union government as the power of ratifying income tax, property tax, inheritance tax, sales tax, service tax, duties and customs tax. Moreover, it allows ratifying interstate sales tax for goods, entertainment and professions, stamp duties in property transfer and collecting lands incomes (owned land).

The local governments on behalf of the state government have the authority to ratify tenement tax and tax at the gate besides receiving the costs of the public facilities such as water, sewage system and etc. from the consumers. More than a half of the incomes of the state and unions governments are supplied from the tax place half of which is indirect tax. More than a quarter of union government financial taxes are shared with the state governments. Tax reforms which were started from 1991 were looking for optimizing the tax system by following certain ways such as reducing rate of tax income of any individuals and companies, indirect taxes and customs duties and raising them, reducing exemptions, grants, simplifying rules and procedures, application of permanent account number to track monetary transaction while increasing tax system follow-ups.

Non-tax income of the central government is supplied from the place of financial services, receipts of interests, dividends of the governmental sector and etc. whereas non-tax income of the states is supplied by sums granted by the central government, receipts interests, public incomes, social and economic services. In Table 1, the direct and indirect taxes of the central and states governments and the sum of both are shown based on the statistics of the Central Bank of India. The share of the interstate in the common sources of Federal tax is appointed according to the recommendations of the Finance Commission for the President.

Table 1. Direct and indirect tax revenues of central and state governments (Based on statistics of Reserve Bank of India) (Billions of rupees)

Year	Center(gross)			States			Center & States combined		
	Direct	Indirect	Total	Direct	Indirect	Total	Direct	Indirect	Total (billion)
2005-06	1652.49	1993.98	3646.47	301.79	1817.68	2119.47	1954.28	3811.66	5765.94
2006-07	2302.49	2412.63	4715.12	388.29	2136.82	2525.11	2690.78	4549.45	7240.23
2007-08	3122.43	2791.04	5913.47	434.46	2427.03	2861.49	3556.89	5218.07	8774.96
2008-09	3338.54	2696.45	6034.99	441.32	2786.73	3228.05	3779.86	5483.18	9263.04
2009-10	3774.87	2438.81	6213.68	473.87	3158.56	3632.43	4248.74	5597.37	9846.11
2010-11	4459.94	3431.78	7891.72	627.25	3981.70	4608.95	5087.19	7413.48	12500.67
2011-12	5006.51	3970.15	8976.66	764.02	4793.77	5557.79	5770.53	8763.92	14534.45
2012-13	5702.57	5027.34	10729.91	902.55	5550.81	6453.36	6605.12	10578.15	17183.27

In 2005-2006, Indian Union Budget equal to 514344 Cr Rs was equal to 118 billion dollars and the Indian tax revenue of equal to 273466 Cr Rs was 63 billion dollars. In 2010, GDP (Gross Domestic Production) of India was equal to 4057787 million dollars according to the report of International Monetary Fund and it was 4194856 million dollars based on the report of the World Bank which has the fourth rank in among all countries in the world. In Diagram 1 and Table 2, the financial indexes of the central government for 2005-2013 are shown per GDP according to the statistics of the Central Bank of India.

Titles Including Income Tax

- Income from Salary

The salary includes cash payment, pension, incentive or commission which is paid monthly or at any other time by one or several employers. The salary consists of the following:1- wages.2- any type of annuity or pensions.3-any type of bonus.4- any fee, commission, raise or benefit which is paid in addition to the salary.5- any advance payment.6-any payment to the employee for each period in which he was out of job.

Table2: Select fiscal indicators of the central government
(As percentage to GDP)(2005-2013)(Based on statistics of Reserve Bank of India)

Year	Gross Tax			Tax Revenue Net	Revenue Receipts	Non Tax Revenue	Capital Receipts
	Direct	Indirect	Total				
2005-06	4.47	5.40	9.87	7.32	9.40	2.08	4.86
2006-07	5.36	5.62	10.98	8.18	10.11	1.94	3.36
2007-08	6.26	5.60	11.86	8.81	10.87	2.05	3.97
2008-09	5.93	4.79	10.72	7.87	9.60	1.72	5.33
2009-10	5.83	3.76	9.59	7.05	8.84	1.79	6.99
2010-11	5.72	4.40	10.12	7.31	10.11	2.80	5.16
2011-12	5.50	4.36	9.86	7.02	8.37	1.36	6.34
2012-13	5.65	4.67	10.32	7.41	8.70	1.29	5.63
2013-14	5.88	4.95	10.83	7.77	9.29	1.51	5.36

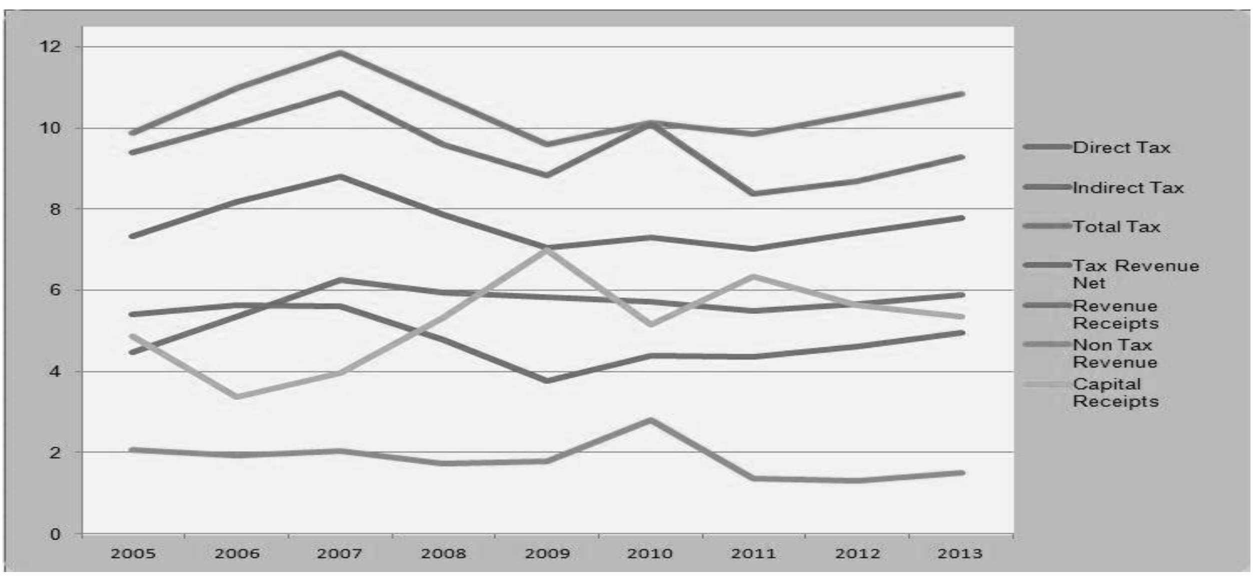

Figure 1. Select fiscal indicators of the central government (As percentage to GDP) (2005-2013)

It is noteworthy to mention that the tax-exempt pensions and transfer payments which are all a part of retirement benefits are not exposed to the tax.

- Income from House Property

The annual value of properties including each building and its land belongings (except the ones which are captured for a business or professions with the income resulting from them exposed to another type of tax) will be exposed to the taxation as “income from house property”. In this respect, this type of income includes only the money resulting from a building or a part of it which is managed by the owner and the income from land belongings. The income resulting from other properties like an open and free area does not include this part and the income resulting from them will be considered as "Income from other sources" which will be discussed later. When a property is rented by an individual for a business or professions, the tax will be regarded for the income from business or professions, not for the property per se. Similarly, when a factory is set up with business and professions purpose in a building owned by the partner, no income from such property is added to the partner's income, unless the factory pays the rent to the partner. If the property is not on the authority of the owner, but he receives money as a rent from the tenant, this income is exposed to tax as" income from other sources". Building includes any building such as office building, warehouse, stockroom, customs warehouse, factory, hall, shop, stalls, theater, conference hall and etc. The income from such buildings or a part of them is exposed to the tax. But the income from unoccupied lands doesn't include this part; even income like the money taken for rent of the land or grassland is regarded as income from other sources. Even the receipt money from open areas or renting a mine is exposed to the income from other sources. The incomes from property which are exempt from any tax are as follows: 1- the income from farmhouse that forms a part of the agricultural income; 2- income from property of local authority; 3- income from property of an officer with the purpose of providing housing or goals as planning for development of cities, provinces and villages or both; 4- income from the registered trade unions; 5- income property from membership in a tribe; 6-income property from a legal firm or a coalition providing from the government; 7-income property from a firm settling by the central government or state authorities to promote the interests of a minority's members; 8-property income from a cooperative firm shaping to promote interests of members of different classes of people in India or members of a tribe or both; 9- property income from renting stockroom or customs warehouse to store, process or facilitate marketing of the goods by an officer according to the law; 10-income from using property for charity purposes; and, 11-income from any political party.

- Income from Business or Professions

Business refers to an activity, a systematic and organized operation with motivation of profitability. The benefit from such activity is known as business. In order to take tax from the incomes as "Business benefits", the following conditions should be met: 1-it should be in a framework of a business or professions; 2-The business or professions should be managed by a tax user; and, 3-Business of professions should have been started by a tax user and from any time in the past year. The following incomes are exposed to the tax with such title:

1. Profit or benefit of any profession which has been started by tax user from any time in the past year.

2- any compensation or money which is payable and possible to be received through the following method: a) Anyone, whatsoever he is called, whether responsible for the whole management or a remarkable part of an Indian company's affairs or dealing with determination of his management or related status change; b) Anyone, whatsoever he is called, whether responsible for the whole management or a remarkable part of an Indian company's affairs or dealing with determination of his company's job or condition change and related status; c) Anyone, whatsoever he is called, having the authority of a part of the activities of an agency relevant to the business of someone else and dealing with

termination of the agency or changing the related status.
3-Income obtained from business, professions or any similar activity resulting from a distinct service for its members. Income benefits from business or other sources depend on the activity of the tax user. If the investment and benefit from it is result of the business part, its income is considered as the income from business. When the income is implicit and the direct result is not business, it is regarded as the income from other sources.

- Income from Capital Gains

Investment means every kind of property which is in the capture of tax user whether in relation to his career or business or not. The investment does not include the following two items: a) any investment in trade, consumable stores or raw materials which are kept for his trade or career. b) personal properties as the ones that could be displaced including clothing and furnishing except jewelry which are utilized by tax user or his family member for personal purposes.

- Income from Other Sources

Certain incomes which are not categorized in the mentioned sources as dividends, money from the lottery, chart, competitions like horse racing or betting, are considered as income from other sources.
Additionally, when a tax user rents his machineries and devices and the building is regarded as an inseparable part of the devices and machineries, the income from such rents are considered as an income from other sources. The prices which are based on Keyman insurance policy and dedicated according to a type of grant, if they aren't considered under title of business benefit, profit or salary are also exposed to such tax. Therefore, this income is a kind of continuer of other incomes and it is regarded in the category of other incomes. Moreover, it is specific for the incomes which are not placed under other titles.

-Tax Avoidance

The tax evasion is using legally the tax programs in favor of a person in order to reduce the payable tax following the law; for example, using tax deductions, changing financial situation of a person through a partnership, opening a firm, association or institution in a country with freely tax laws.
The tax evasion could result in beneficial effects: a) Reforming unreasonable financial laws; b) facilitating commercial transportations which are not feasible in the presence of heavy taxes; and, c) providing a legal path for the people who want to evade tax payment. However, the tax avoidance reduces the governmental income and the tax system will get into trouble.

- Tax Evasion

In contrast to the tax avoidance, tax evasion is a term related to the attempts of any individuals, companies, unions not to pay their taxes illegally. The tax evasion includes activities of any individuals who hide the real fruit of their activities and properties or report them wrongly in order to reduce the including tax (instances such as lack of reporting the income honestly, profit or benefit or exaggeration in deductions' announcement. The tax evasion is a crime in almost all countries and committing it will be followed by imprisonment.

Conclusion

One of the most important factors that have direct effect on the economic atmosphere of the developing countries is financial policy. In fact, the financial system is one of the most consistent mechanisms of determining the degree of development in the countries and guarantor of implementation of the most significant activities of a government. As a rule, the financial supply of the public sectors and others depends on the size of the national budget and the size of the national budget depends on the efficiency of the tax system and economic level of the government. Actually, the economy in which the financial policies play a significant role consists of issues such as the national budget and condition of finance supplying for the public and other sectors. Nonetheless, while solving problems and question related to supply of the national budget through tax, this question should be precisely answered in such a way that priorities should be adopted in organization of the financial system. Regarding financial systems in various countries, economists have different views about achieving an appropriate financial system with specific conditions in each country. In the issues raised by the economists, the greatest emphasis is on transparency and tax distribution, tariff level, various tax systems and problems related to inflow of budget, investment flows and level of the underground economy. In connection with this issue, the experiences of some countries such as India and Malaysia which have gained successes on development of economic macroeconomic indexes through attracting the investors for the tax system are noteworthy. Reduction of tax rates and clarification is one of the utilized approaches in modifying tax systems of such countries which has had significant effects on the macroeconomic indexes, finally resulting in the economic development and growth.

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