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TAXATION AND SAVINGS

OUR tax policy seems to be based on the assumption that taxation which transfers resources from the people to Government tends to increase the total savings resources of the nation and enables a higher rate of growth. This assumption has not been properly examined and is almost taken for granted. The First Plan itself had suggested that "enlargement of public savings through taxation.....is one of the major means open in the present state of our organisation to raise significantly the level of net savings in the country.[1] This has been the working hypothesis for the subsequent plans and, as a result, the tax level has been put up almost each year since 1951.

It is proposed to examine in this Paper whether taxation really leads to an increase in the savings rate. To simplify the problem, the economy has been divided into three main sectors which reveal distinct savings behaviour. These sectors are—

1. Government,
2. Corporate Sector, and
3. Households
   a. urban
   b. rural

The propensity to save of each of these sectors is different. When there is a transfer of income from one sector to the other there will be an increase in national savings if the recipient sector has a higher propensity to save. Taxation, therefore, would increase national savings, if and only if, the propensity to save of Government is higher than that of the corporate sector or the household sector. It is this proposition which has to be examined in detail.

GOVERNMENT FINANCES AND SAVINGS

Government acquires resources in a variety of ways. Some of these

are capital receipts and represent mere transfer of savings from one sector to the other. This is true, for example, of market borrowing, unfounded debt, or deposits of various kinds. The savings of Government come from its current receipts. These receipts are obtained mainly from taxation. But there are also non-tax current receipts like interest, contributions from departmental undertakings, dividends of commercial and other undertakings, surplus profit of the RBI and receipts from administrative service, social and developmental services like education, medical, public health, broadcasting, etc., public works receipts, revenues of ports, light-houses, and so on. From current receipts Government has to finance current expenditures on items like defence, interest on public debt, administrative services, social and developmental services, etc.

Government's receipts, expenditures and savings have increased over the years 1955-56 [2] in the following manner[3].

(Rs. crores)

	Current Revenue	*Current Expenditure*	*Savings*
1955-56	1024	912	111
1964-65 ..	3716	3165	555

It is evident that Government does not save the whole of the additional revenue which accrues in the year. A substantial part of it is absorbed by current expenditures. Looking at the trends in the years 1955-65 for which figures are available, the relationship between savings and current revenues will be given by the following equation:[4]

$$Sg = -45 + 0.17Yg \quad \ldots\ldots\ldots\ldots\ldots\ldots (1)$$

where Sg is Government savings and Yg is Government income (in Rs. crores)

The marginal propensity to save of Government, as found from equation (1), is 0.17. That is to say, an increase in current revenues of Government by Rs. 100 crores would increase Government savings, on an average, by Rs. 17 crores. The balance viz. Rs. 83 crores will be used for current expenditures. This happens because Government has not been able to have sufficient control over the expenditure flows. There has been a persistent trend for these expenditures to go up. As a proportion of national income, non-developmental expenditure of Government increased from 8 per cent in 1962-63 to 11 per cent in 1967-68. This increase was not wholly due to the additional defence

outlay. In fact non-development civil expenditure increased much more. Government has shown ample awareness of the need to reduce non-productive expenditure. But in each successive Budget expenditure on these items has almost invariably increased. A study about the expenditures of Central Government alone for 1967-68 reveals that it was possible to reduce non-developmental civil expenditure to the extent of Rs. 87 crores on following main heads :

	(Rs. crores)
Administrative services	14
Social & Development services	23
Public works, misc. etc.	29
Grants to States for current expenditure ..	21
Total	87

The phenomenal growth in non-developmental expenditure has tended to suppress Government's capacity to save. From equation (1) it is established that, on an average, Government will save only Rs. 17 crores out of an additional income of Rs. 100 crores. On this basis, national savings will increase through taxation only if the propensity to save for the corporate sector and the household sector is less than 17 per cent.

CORPORATE INCOME AND SAVINGS

Savings behaviour of the corporate sector is different from that of Government or the households. The corporate sector has to make a number of payments from profits before it is able to save at all. Profits themselves depend on the price, on the one hand, and the cost of production, on the other, both of which are not within the control of the corporate sector. The profits (after providing for depreciation) are distributed on three main items, viz.—

Corporate taxation

Dividends

Retained earnings (i.e. savings)

The savings of the corporate sector are thus a residue left after payment of taxes and dividends. The tax provision is governed by the tax rates imposed by Government. Dividends are paid out in accordance with net profits and current market expectations. The retained

earnings, therefore, will be small until aggregate profits are large enough to pay out taxes and the market rate of dividend. The bulk of profits in excess of this amount will be retained for ploughing back. For this reason, the average propensity to save of the corporate sector tends to be much smaller than the marginal propensity to save. Considering the net income of the corporate sector for the years, 1955-65, the savings behaviour of the corporate sector can be described in terms of equation (2) [5].

$$S_c = -95 + 07c.6\ Y_c \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (2)$$

where Sc is corporate savings and Yc is corporate income after payment of Taxes (in Rs. crores)[6]

Equation (2) briefly describes that profits in excess of Rs. 95 crores will be saved to the extent of 76 per cent. That is to say, an increase in corporate taxation which reduces net corporate profits by Rs. 100 crores will reduce corporate savings by Rs. 76 crores. It has also been observed earlier that an increase in tax revenue of Government by Rs. 100 crores increases Government savings by Rs. 17 crores. It therefore follows that an increase in corporate taxation will reduce national savings because the marginal propensity to save of the corporate sector is much higher than that of Government. More precisely a Rs. 100 crores increase in corporate taxation will reduce national savings by Rs. 59 crores. (This is because the transfer of Rs. 100 crores from the corporate sector will cut corporate savings by Rs. 76 crores and increase Government savings by Rs. 17 crores, thus reducing total savings by Rs. 59 crores).

Savings of Households

The household sector is a complex group and it would be too much of a generalisation to treat it as a single sector. But relevant statistics of income and savings are not available for different sub-groups except for urban and rural households. The analysis, therefore, is done separately for these two sub-groups which have distinct characteristics of their own.

Urban households derive most of the income from secondary and tertiary activities. Incomes from these sources are stable and it is, therefore, possible for urban households generally to make regular savings. A part of the income of the households is transferred to Go-

vernment by way of taxation. This taxation can be either direct (e.g. income tax, wealth tax etc.) or indirect (e.g. excise duties, sales tax, customs duties etc.) Almost the whole of the direct taxes which are collected by Government, excepting the agricultural income-tax and land revenue, impinge on urban households. Indirect taxes are paid both by the urban as well as by the rural households and it is difficult to make an exact estimate of the extent of indirect taxes paid by the urban and the rural households separately. For the purpose of our analysis a notional distribution of indirect taxes between urban and rural sectors is made, assuming that indirect taxes bear a constant proportion to expenditures. Relating the net income of the urban sector (after deducting taxes) to urban savings for the years 1955-65 the savings behaviour of the urban households would be described by equation(3) [7].

$$S_{uh} = -330 + 0.22\, Y_{uh} \ldots\ldots\ldots\ldots (3)$$

where S_{uh} is savings of the urban households and Y_{uh} is net urban income after payment of taxes. (in Rs. crores).

The urban households, as can be expected, will not save until they have a certain minimum income. When income exceeds that minimum amount, 22 per cent of the additional income will be saved. That is to say an increase in the income of urban households by Rs. 100 crores would increase urban savings by Rs. 22 crores. Looked at the other way, if Rs. 100 crores are taken away by Government by way of taxation urban savings will be reduced by Rs. 22 crores. It was also seen above that an increase in Government income by Rs. 100 crores would increase Government savings by Rs. 17 crores. It would then follow that a transfer of Rs. 100 crores from the urban households to Government by way of taxation would reduce national savings by Rs. 5 crores.

The savings propensity of the agricultural sector stands in sharp contrast with that of the corporate sector or urban households. This may be because generally the per capita income in the rural sector is rather low and income itself is not stable.

For estimating the net disposable income of the agricultural sector taxes like land revenue, agricultural income-tax and a proportionate part of indirect taxes have been deducted from aggregate rural income. By relating rural savings to net rural income[8] the marginal saving propensity is found to be only about 4 per cent. The savings equation

in respect of the rural sector is :

$$S_{rh} = -15 + 0.04\ Y_{rh} \quad \ldots\ldots\ldots\ldots\ldots (4)$$

where S_{rh} is rural household savings and Y_{rh} is net rural household Income (in Rs. crores).

It is immediately apparent that the saving propensity of the rural household sector is very much lower than that of Government. As such, a transfer of income by way of taxation from rural households to Government would increase national savings. For example, a transfer of Rs. 100 crores from the rural households to Government would reduce rural savings by Rs. 4 crores but would increase Government savings by Rs. 17 crores. There would thus be a net increase in national savings by Rs. 13 crores.

TAX MEASURES FOR INCREASING SAVINGS

From the analysis made so far it is clear that taxation can increase national savings only in very special circumstances. Generally, taxation reduces national savings because the marginal propensity to save of Government is very much less than that of the corporate sector or urban households. For example, an increase in taxes on the corporate sector would reduce national savings by 59 per cent of the additional tax revenue. Similarly, taxation of urban households would reduce national savings by about 5 per cent of the additional taxation. However, transfer of income from rural households to Government tends to increase national savings to the extent of 13 per cent of the additional tax effort. It therefore follows that if taxation has to be used as an instrument for increasing national savings to finance development it should be directed towards the rural sector of the economy which has a low saving propensity. But it is precisely the rural sector which has, by and large, escaped the incidence of taxation. This is particularly so in respect of direct taxation. For example, the revenue receipts from land revenue increased from Rs. 48 crores in 1951-52 to Rs. 123 crores in 1963-64 and thereafter declined to only Rs. 90 crores in 1966-67. The agricultural income-tax increased from Rs. 4·3 crores in 1951-52 to Rs. 10·5 crores in1966-67. In contrast to these figures the total tax revenue of the Centre and the States went up from Rs. 627 crores in 1950-51 to Rs. 3,606 crores in 1967-68. Although the rural sector has got off lightly with regard to direct taxa-

tion it may have borne its share of indirect taxation. But the incidence of indirect taxation is uncertain and it is difficult to find out how much of the revenue from indirect taxation really comes from the rural sector.

Taxation of agriculture, which can be the main source of additional tax revenue, has been a political question. Although it is generally recognised, even in Government circles, that agriculture has a large tax potential, State Governments have been hesitant to impose any significant amount of taxes on agricultural income. In fact, a number of States have abolished or reduced land revenue without its being replaced adequately by agricultural income-tax. It is also difficult to devise any scheme of indirect-taxation which would draw-out income from the rural sector. A step in this direction was taken by the Central Government in 1969 Budget when it imposed a tax on fertilisers. The Planning Commission has suggested measures like increase in irrigation levies, agricultural income tax and floating of rural debentures. This change in the pattern of taxation indicates that Government and Planning Commission have come to realise that urban taxation has reached a point of no return and recourse to rural income, if additional taxation is at all necessary, has become inevitable.

The analysis made above thus leads to the inevitable conclusion that taxation except under special circumstances does not increase national savings. Taxation is not really an economic way of financing Government investment. Since national development is of greater importance than development of public sector as such, Government must depend more on borrowing rather than on taxation. The fall in the rate of savings almost from the beginning of the Third Plan from 10 percent to 8 percent can be explained by the high rate of taxation which transferred income from the corporate sector and urban households, which have a higher propensity to save, to Government which has a lower propensity to save. Until such compulsory transfers are stopped and, in fact, reversed, improvement in national savings and, therefore, in national investment and growth, may become difficult.

REFERENCES

[1[First Five Year Plan. p.48
[2] The period 1955-65 has been taken because for later years data about savings is not available.
[3] For details see Appendix II.
[4] For methodology see Appendix I,
[5] See Appendix III.
[6] Estimates of savings and net income of the corporate sector are made on the basis of the figures from RBI sample of 1333 companies.
[7] See Appendix IV.
[8] See Appendix V.

APPENDIX I

ESTIMATE OF MARGINAL PROPENSITY TO SAVE

The marginal propensity to save is the ratio of the increase in savings to the increase in income. If the income of, say, the household sector goes up by Rs. 100 crores, which consequently increases its savings by Rs. 15 crores, the marginal propensity to save would be 0·15 or 15 per cent.

The data about savings and income which is available only upto 1964-65 has been analysed to find out the marginal propensity to save of Government, corporate sector and households. The marginal propens'ty to save will, as can be expected, vary from year to year. But if the whole period is taken together these fluctuations appear to take place around a trend-line which is different for different sectors.

To estimate this trend line the data in respect of income and savings is plotted on a graph paper and a line of best fit is traced in a manner that would represent minimum deviations. The slope of the trend line indicates the marginal propensity to save.

The marginal propensity to save for the four different sectors, viz., Government, corporate sector, urban households and rural households, is found to be 17 per cent, 76 per cent, 22 per cent, and 4 per cent respectively. In making these estimates of marginal propensity to save, the distribution of income within each sector is assumed to be constant. With changes in the distribution of income the propensity to persons with higher or lower propensity to save.

APPENDIX II

Current Revenue, Expenditure and Savings of Government

(1955-56 to 1964-65)

(*Rs. crores*)

Year	*Current Revenue*			Current Expenditure	Savings
	Tax Revenue	Non-tax Revenue	Total		
1955-56 ..	767·61	255·95	1023·56	912·16	111·4
1956-57 ..	860·49	273·40	1133·89	957·19	176·7
1957-58 ..	1047·31	337·78	1385·09	1228·39	156·7
1958-59 ..	1096·12	392·68	1488·80	1350·80	138·0
1959-60 ..	1221·86	475·72	1687·58	1484·78	202·8
1960-61 ..	1394·92	534·35	1929·27	1689·87	239·4
1961-62 ..	1537·95	572·42	2110·27	1755·87	354·4
1962-63 ..	1854·83	856·46	2711·39	2303·59	407·8
1963-64 ..	2113·39	1022·94	3136·33	2609·73	526·6
1964-65 ..	2585·22	1130·36	3715·58	3165·08	550·5

APPENDIX III

Income & Savings of the Corporate Sector

(1955-56 to 1964-65)

(*Rs. Crores*)

Year	Gross Income	Taxation	Net Income (Col. 1 – Col.2)	Savings
	(1)	(2)	(3)	(4)
1955-56	244·80	37·04	207·06	60·00
1956-57	269·90	51·18	218·72	59·50
1957-58	206·90	56·13	150·77	18·00
1958-59	230·00	54·33	175·67	32·40
1959-60	301·80	106·56	195·24	57·60
1960-61	382·90	111·05	271·85	106·70
1961-62	426:30	156·46	269·84	102·80
1962-63	470·91	221·50	249·40	108·10
1963-64	570·10	274·59	295·51	126·20
1964-65	583·80	314·05	269·75	80·90

*Calculated on the basis of the RBI sample of 1333 companies.

APPENDIX IV

Income & Savings of the Urban Sector

(1955-56 *to* 1964-65).

(*Rs. Crores*)

Year	Gross Income	Taxation	Net Income	Savings
1955-56	4355·20	547·43	3807.77	645·4
1956-57	4570·10	582.02	3895·08	653·5
1957-58	4883·10	729.78	4153·32	443·6
1958-59	5010·00	742.13	4267·87	548·8
1959-60	5238·20	787.64	4450·56	629·1
1960-61	5547·10	917.11	4629·99	791·5
1961-62	5963·70	982.06	4981·64	685·6
1962-63	6259·10	1154.52	5104·58	746·6
1963-64	6589·90	1263.33	5326·57	N.A.
1964-65	6446·20	1585.16	4860·05	N.A.

APPENDIX V

Income & Savings of the Rural Sector

(1955-56 *to* 1964-65)

(*Rs. Crores*)

Year	Gross Income	Taxation	Net Income	Savings
1955-56	4520·00	183·14	4336·86	153·7
1956-57	5520·00	224·29	5295·71	187·7
1957-58	5280·00	261·40	5018·60	179·5
1958-59	6240·00	299·66	5940·34	212·2
1959-60	6250·00	327·66	5922·34	212·5
1960-61	6890 00	366·76	6523·24	234·3
1961-62	6960·00	399·43	6560·57	236·6
1962-63	7000 00	479·21	6520·79	237 0
1963-64	8170 00	575·47	7594·53	N.A.
1964-65	10870·00	686 01	10184·99	N.A.