

FISCAL POLICY IN NORTH-EAST INDIA



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B. MISHRA

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Fiscal Policy in North-East India

© Authors

First Published 2006

ISBN 81-8370-063-2

Call No..... 336.3095416

Acc. No..... 7980

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PRINTED IN INDIA

Published by M.P. Misra for Akansha Publishing House, New Delhi
and Printed at Aryan Enterprises, Delhi

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PREFACE

Over a period of time, North-Eastern states have developed a dependency syndrome as it is evident from an explosive cycle of public expenditure growth in most of the states of the region, coupled with an increasing demand for grants-in-aids and other Central assistance to bridge the gap of large budgetary deficits. The inadequacy in generating their own sources of revenue to meet the challenge of a volatile fiscal situation may be attributed to a number of factors. They are : (i) the low level of economic activities coupled with a low level of economic base, which may be considered as a product of low level of infrastructural development (ii) emergence of a parallel economy not only due to flourishing trade of imported goods and commodities from the neighboring countries but also due to the various fringe tax benefits of direct taxation particularly of Income tax and lastly (iii) due to the social unrest and political instability that these economies experience from time to time. As a whole, the repercussion effects of all these forces at work has resulted in various leakages not only in tax generating capacity but also in narrowing down the tax base of various taxes in the region. If we are to assign a cause- effect relationship to this type of vexed problem then we can argue that the failures on the part of the state governments in this region to mobilize adequate financial resources in order to carry out their various developmental plan programs, has been mainly responsible

for their low level of economic activities, low level of economic base and their final culmination in the form of social unrest. This poor state of affairs in the fiscal front of the North-Eastern states may be termed as *tribal fiscal dilemma* that haunts all the north-eastern states. In a welfare characterized state, fulfillment of social desire to have a better quality of life is dependent not only on the capacity of the government to mobilize adequate resources but also on the degree of momentum of the economic activities that a state in question attains. In the absence of a desired level of economic tolerance to the expanded economic activities, mobilizations of adequate resources for carrying out their developmental works are left to the mercy of the capacity of the government to mobilize adequate resources.

The book is an attempt to accomplish the above anomalies by analyzing fiscal position of Northeastern states from the angles of resource mobilization (level of revenue) and its utilization (level of public expenditure). By applying four indicators, viz. compound growth rate, marginal tax rates, and elasticity and buoyancy coefficients to the North-Eastern states tax structure, the present book tries to assess the fiscal performances of these states in terms of their problems and prospects to achieve a reasonable degree fiscal capacity to carry out their developmental works.

I hope that the present book will prove to be of immense value to the post-graduate students, Research scholars, fiscal analysts and the taxation theorists. I believe that the book will seek to offer a guideline for further intellectual exercises on the same line.

I would like to place on record my deep sense of indebtedness to Prof. T. Mathew, from whom I learnt and developed an interest for Public Finance.

My obligations to all my colleagues in the Department of Economics, NEHU, Shillong, who have been the guiding spirit

and the beacon light in all my endeavors, shall remain ever unpaid.

I owe a special debt of gratitude to Prof. E.D.Thomas, Prof. S.K.Mishra and Prof. P.Nayak and Dr. P.S. Suresh who have helped and encouraged me in various ways while preparing the manuscript.

I find no words to give my innermost feelings for my wife (Sujata) and my son (Echo) for their silent sacrifices without which, I could not have dreamt of completing this work.

I dedicate this humble work to all of teachers who taught me Economics.

B. Mishra

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CHAPTER: I

INTRODUCTION

1.1 Background of the Study

In recent years the government activities vis-à-vis public expenditure have grown both relatively and absolutely in all the states of the Indian federation. With the expansion of the Governmental activities, the magnitude of plan expenditures of the state Governments have increased tremendously which in turn has given rise to the need for a rapid increase in revenue. This has resulted in a situation where, most of the state Governments have increasingly begun to restructure their tax system to generate higher revenue or to improve the taxable capacity or tax efforts with a motive to counterbalance the ever increasing public expenditures. Further it is generally felt that to a large extent, the financial problems of the state arise from its lack of tax efforts, i.e. its failure to mobilize adequate resources to meet its increasing demand for various developmental public expenditure programmes. In working out a developmental plan which implicitly takes into account both the tax and public expenditure ratios; a major question that always arises is how much tax and non-tax revenues can a country/ state reasonably expect to raise and what sources should be tapped in order to meet the ever increasing demand for public expenditures so as to bridge up the widening fiscal gap?

In a federal set up, the financing of the state development plans depends to a great extent on the mobilization of resources by the state Governments mainly through the imposition of varieties of taxation. Efforts made in this direction from time to time have not uniformly succeeded. Being federal in structure, the state Governments has limited statutory powers to levy taxes to finance its various infrastructural facilities and welfare programmes. This may be ascribed to the fact that while bulk of the federal revenue has been derived from more elastic sources, implying that the revenue from these taxes increases proportionately, if not faster than income, the sources of the state Government are relatively less elastic, as reported by Rao (1992)¹.

Further, in the recent past, the Federal Government has signaled a general resource crunch. This has necessitated reduction on outlays on the centrally sponsored development schemes to the states on the one hand and a major cut in subsidies and grants on the other. Thus, the outlays of the states have been substantially affected, thereby forcing the State Governments to postpone some of their developmental programmes. This has no doubt slowed down the pace of economic development of the states. As a result the existing pattern of resource allocation of the financial resources between the union of India and its constituent units has generated imbalances between the revenue capacities and the needs of the states much to the disadvantage of the backward states and particularly the states in north-eastern India. In this context, the present study is a humble attempt to enquire into the nature, causes and dimensions of such maladjustments and imbalances in different states in North-Eastern Region.

With the expansion of the Governmental activities, the magnitude of plan expenditures of the state Governments have increased tremendously which in turn has given rise to the need for a rapid increase in revenue. It is expected that,

the sources of revenue should grow automatically at the required rate. But the experiences of most of the state Governments in India negate the above proposition. As a result of which, this has created a widening gap between the state's expenditure responsibilities on the one hand and available resources on the other, thereby giving rise to the problem of attaining an appropriate degree of financial self-reliance on the part of the most of the state Governments in India. However it is also felt that to a large extent, the financial problems of the states arise owing to lack of tax efforts on their own part to raise additional resources. On this account, the need for an in-depth analysis of the fiscal anomalies at the state level has been felt for quite some time.

In federal India, the emergence of a situation is evident in which, some states are excessively dependent on federal transfers, while others resort extensively to overdrafts, which can be attributed either to the failure on the part of the state Governments in tapping all the productive sources of revenue or to the fact that a 'critical limit' as regards to tax effort as well as taxable capacity has already reached in case of most the states. This excessive dependence of the states on the centre is not all conducive to the development of sound federal fiscal conventions. This scenario makes a strong case for analyzing the states fiscal condition.

Thus the existing pattern of resource allocation of the financial resources between the union of India and its constituent units has generated imbalances between the revenue capacities and the needs of the States much to the disadvantage of the backward states of India. In this particular context, we have made a successful attempt at enquiring into the nature, causes and dimensions of such maladjustments and imbalances, taking North-Eastern Regions as typically backward states.

To counter balance this, it is believed, that the State Governments may have to resort to either of the following two alternatives to seek higher revenue.

- (i) The first recourse before the State Governments may be to re-structure their tax system in such a way so as to yield more revenue. But, the manner in which increasing revenue may be realized through a properly structured tax system at any given time is largely conditioned not only by the various socio-economic and political factors, but also by the efficiency of the State's administrative apparatus, which sets important limits to the ambit, pattern and structure of taxation (Lakdawala, D. T. and Nambiar, K. V., 1972)². We must make absolutely clear at the outset that, there has been no attempt on our part to go into this particular aspect of the problem.
- (ii) The second alternative that we can spell out runs in terms of improving the revenue elasticity and buoyancy of the tax structure, so that the tax system will show an automatic response to the growth of the Net State's Domestic Product. The high degree of tax responsiveness to our view may set a limit to an 'optimal level' of taxation on the one hand and to an 'optimal level' of tax effort on the other. To what extent, the State's Government can achieve or have already achieved this objective is an open question. Therefore, the present study is a modest effort in this direction to find out a suitable answer to the above question, by taking into account this second aspect of the problem of State's finances.

1.2 Problem Formulation

Over a period of time, North-Eastern states have developed a dependency syndrome as it is evident from an explosive cycle of public expenditure growth in most of the states of the region, coupled with an increasing demand for grants-in-aids and other Central assistance to bridge the gap of large budgetary deficits. The inadequacy in generating their own sources of revenue to meet the challenge of a volatile

fiscal situation may be attributed to a number of factors. They are : (i) the low level of economic activities coupled with a low level of economic base, which may be considered as a product of low level of infrastructural development (ii) emergence of a parallel economy not only due to flourishing trade of imported goods and commodities from the neighboring countries but also due to the various fringe tax benefits of direct taxation particularly of Income tax and lastly (iii) due to the social unrest and political instability that these economies experience from time to time. As a whole, the repercussion effects of all these forces at work has resulted in various leakages not only in tax generating capacity but also in narrowing down the tax base of various taxes in the region. If we are to assign a cause- effect relationship to this type of vexed problem then we can argue that the failures on the part of the state governments in this region to mobilize adequate financial resources in order to carry out their various developmental plan programs, has been mainly responsible for their low level of economic activities, low level of economic base and their final culmination in the form of social unrest.

It is evident from the above discussion that most of the State Governments in Indian Federation face severe budgetary pressures with rising demand for expenditures. Further, it is generally argued that the financial problems of the States arise from their lack of tax efforts, i.e., their failure to mobilize adequate resources from sources within their own jurisdiction. As a result of which, the financial dependence of the States on the Union Government has been on the increase in recent years. However, it is felt that, the resources available to the States under present dispensation are not adequate for meeting their requirements. We intend to accomplish this by analyzing fiscal position of Northeastern states from the angles of resource mobilisation (level of revenue) and its utilization (level of public expenditure)

North-Eastern region is comparatively a background

region, where agriculture is the predominant sector, providing means of livelihood to more than 85 percent of the population. Though significant development has taken place in some sphere since Independence, access to opportunities for a 'reasonably minimum' standard of living in this region is one of the lowest in the country. The fiscal health of the states in this region is by no means encouraging at all, where the States' Own Tax Revenue contributes hardly 17 percent of the total tax receipts of the states. Further, the tax revenue constitutes near about 13 percent of the aggregate revenue of the states. In these states, where the states' own tax revenue contributes no more than 10 percent of the state's income and the aggregate Government expenditures constitutes about 115 percent of the state's income. If, we are allowed to use a terminology for this poor state of fiscal affairs, then we will call it a *tribal fiscal dilemma* that haunts all the north-eastern states. In a welfare characterized state, fulfillment of social desire to have a better quality of life is dependent not only on the capacity of the government to mobilize adequate resources but also on the degree of momentum of the economic activities that a state in question attains. In the absence of a desired level of economic tolerance to the expanded economic activities, mobilizations of adequate resources for carrying out their developmental works are left to the mercy of taxable capacity of the states. It is against this back ground, we intend to undertake an inter-temporal study on the efficiency of the tax system in various states in the North Eastern Region. It is, therefore, worthwhile to study the various aspects of the effects of state taxation and expenditures and the dimensions of its movements over the years.

Thus, the overall picture that emerges is that, the tax generating capacity of the North-Eastern states does not cope up with its increased public expenditure programmes, for achieving a desirable rate of economic progress. This exhibits

clearly the low level of tax effort measures on the part of the state governments in the overall scheme of resource mobilization for developmental purposes. As a result of which, economic backwardness has been the resultant outcome.

Based on the above logic, it can be argued that if North-Eastern states' tax policy is to serve the ends of economic development, it should aim to attain at least two objectives³. One of the most powerful instruments of resource mobilization is considered to be the tax system. Therefore, the tax system should aim at (I) in siphoning off into the state exchequer as much revenues as can be gathered in the tax net (without discouraging the incentives for private savings and investment) and (ii) in helping to release resources for private (or public) investment by reducing current consumption.

In the back drop of the above facts, the study argues that the remedial approach to tackle the ever increasing fiscal gap lies in attaining an appropriate degree of financial self-reliance. No doubt, any attempt by the state governments to achieve financial self-reliance will depend upon a sound fiscal capacity. Further, a sound fiscal capacity of a state remains the logical off-shoot of a highly productive, responsive and efficient tax structure. To what extent North-Eastern states' tax system adheres to the notion of sound fiscal capacity remains an open question. Therefore, the two major research questions that we have touched upon in this context are: (i) to measure the extent to which the revenue capacity of these states' tax system has been realized and (ii) to assess the overall success of government measures to increase revenue potentialities of the tax system and the North-Eastern states' overall capacities to raise the tax-income ratio overtime.

There are six available indicators to assess North-Eastern states' performance with respect to the above two objectives. These indicators are: buoyancy and elasticity, compound growth rate, marginal tax rate, tax ratio and tax effort of the tax system in vogue. Of these six indicators, the tax ratio

and the tax effort measures generally do not indicate the efficacy of the revenue structure of the states' government as they do not take into account the taxable capacity. Thus, we are left with the choice of applying the compound growth rate and marginal tax rates and elasticity and buoyancy coefficients to the tax structure so as to assess directly the productivity, efficiency and responsiveness of states' tax structure. So, it is clear that, if the state's tax structure satisfies four conditions, namely, that: (i) the marginal tax rate increases with every increase in per capita income; (ii) average tax rate responds positively to the changes in tax base, (iii) the buoyancy of taxes is substantially higher than unity; and (iv) the elasticity is equal to or marginally greater than unity, then it can be said that the states tax system/ resource mobilization programmes have performed satisfactorily, given its relative taxable capacity. The effectiveness of North-Eastern states' tax system is assessed in the context of these four norms.

On the state level, tax revenue may change through automatic response of the tax yield to changes in State Income and, or, through the imposition of new taxes, revision of the rates, stricter tax compliance and other administrative measures backed by legal action. Changes in the tax yield resulting from modifying such tax parameters (i.e., rates, bases etc.) are called discretionary changes, which may incidentally involve some legislative action. Changes in the tax yield flowing from the combined effects of automatic responses as well as discretionary changes constitute the "buoyancy" of a tax. On the other hand, with tax parameters held constant (i.e., discretionary changes being removed) automatic changes in the tax yield resulting from variations in the state income measures the "elasticity" of a tax or a tax system.

The need for undertaking such an analysis for the state taxation in North-Eastern States arises due to the following reasons.

Since the buoyancy coefficient compares the actual growth of tax revenue with the growth in State Income, it indicates the following resultant outcome. First, it helps in assessing the overall success of Government's measures to increase tax revenue. Secondly, to the extent that the buoyancy is low, it would suggest a need for devising a tax structure which would overcome the deficiencies. Thirdly, on the basis of such study, the state Government can estimate the probable tax revenue with unchanged base and the rate of tax, consequent on more increase in the State Income.

The elasticity coefficient on the other hand, indicates the inherent responsiveness of a tax system to changes in the State Income and also it reflects, how far the revenue potential of a given tax system has been realized.

It is against this theoretical problem, a humble attempt is being made in this work, to throw some light on the problems of estimating elasticity and buoyancy of the state taxes in the North-Eastern Region, in order to determine the degree of responsiveness of the state taxes to the state's Domestic Product. This is to our view will exhibit the relative degree of efficiency of state tax measures and will indicate the extent of additional tax efforts needed to increase the revenue of the Government.

1.3 Scope and Objectives of the Study

The study covered a period of 38 years from 1963 to 2001. This is a period during which the North-Eastern States' economy has passed through phases of both upswing and downswing owing to wide fluctuations in their agricultural sector as well as political instability and social tensions. Further, this entire period witnessed political instability and social tensions leading to substantial changes both in its expenditure and taxation policies in the entire North-eastern States. It may be mentioned here that the relevant data on discretionary changes in tax revenue are unavailable for the states of Mizoram, Tripura, Manipur and Arunachal Pradesh.

Therefore, for the purpose of inter state comparison of the elasticity and buoyancy coefficients within the North-Eastern region; we made an attempt to estimate the discretionary response of the various taxes of these states by taking into account the tax base of various taxes and the the changes in tax rates over the years. To that extent, the tax responsiveness analysis of these states may slightly over state or under state the results. It may be mentioned that wherever possible, for the inter-state comparison within the North-Eastern region, we thought it imperative to take two representative states, namely Meghalaya and Nagaland as the area of our study. The reason for choosing these two states is one fold. It is observed that in recent years, the state of Meghalaya has preferred to maintain a surplus budget while that of the state of Nagaland continues to have a deficit budget over the years. Thus, we believe that inter state comparison between these two representative states may throw some light on the scope of additional resource mobilisation and the resultant patterns of its utilization in other different states of North-Eastern region. Keeping these general problems in view, an attempt has been made in this work to study in detail the following aspects of state taxes.

- (i) An assessment of the overall success of the Government measures to increase Government revenue.
- (ii) An analysis of the growth of tax revenue consequent on the growth of Gross State Domestic Product and, to determine the extent to which the North-eastern region's tax system is responsive to changes in State Income overtime.
- (iii) To measure the extent to which the revenue potential of the North-eastern region's tax system has been realized.

However, the main focus of our study as mentioned earlier has been on the analysis of elasticity and buoyancy

of the tax system as a whole and of each individual tax to changes in tax base and in the State Income.

1.4. Sources and Limitation of Data

The study has been based primarily on the secondary sources of data. The main sources of data are; Annual budgets/ Finance account of the various state governments including their memorandum submitted to the various finance commissions for the period covered by our study. Whenever possible, the budgetary data relating to India published in CMIE and RBI annual reports on Currency and Finance were used and consulted. We have also used wherever possible the budgetary data relating to India as published from time to time in the Reserve Bank Bulletin and the RBI annual reports on Currency and Finance.

1.5 Methodology

The data has been analyzed with the help of suitable statistical techniques and the results obtained have been subjected to relevant economic logic.

Simple regression equations are fitted to the data (by the method of least square) to estimate the trends and fluctuations in revenues and expenditures of the two representative states of North-Eastern region for the period under study. To study the shifts in the relative shares of various taxes and non-tax sources in states' own revenue, we have made use of the statistical technique of time series analysis. Specific techniques and measures are described fully as and when used.

1.6. Work Plan

The topical organization of the work is as follows. For the purpose of expositional convenience and systematic analysis, the work has been divided into six parts namely (1) Introduction, (2) Review of Literature and Methodology (3) problems and prospects of resource mobilisation of the states (4) Expenditure policies of the states (5) Elasticity and

buoyancy of state tax system as a whole and that of individual taxes, and (6) Policy Implications.

Chapter -1 is intended to be Introductory in nature. In this section, we have addressed ourselves to the intricate problems and issues involved in the state finance. Besides, this chapter also incorporates a description of the methodology followed in this study and the sources and limitations of data.

Chapter-II is devoted to the statistical methods used to evaluate the fiscal position of the North-Eastern states. An attempt has been made to give a comprehensive account of the major conceptual and empirical issues relating to the analysis of tax efforts and tax responsiveness. An attempt is made to develop an alternative model of elasticity and buoyancy for measuring the responsiveness of North-Eastern Region's tax system by taking into account the difficulties associated with the estimation of elasticity and buoyancy of the tax system.

Chapter - III is an attempt to examine the problems and prospects of financial resources of the states. The purpose of this is to present an over view of all the states' finance for determining the degree of financial dependency of the state on the Union government. An attempt has also been made in this chapter to determine the extent to which North-Eastern region's economy is financially self-reliant in mobilizing adequate resources from sources within its own jurisdiction. An attempt is made in this chapter to apply the first group of indicators as mentioned earlier, i.e. Compound growth rate, Marginal and Average tax rate to assess the level of fiscal tolerance of the region.

Chapter - IV is concerned with the critical analysis of public expenditure growth, where we made an attempt to assess the overall utilization pattern of the states' financial resources for the entire 38 years covered by our study. We

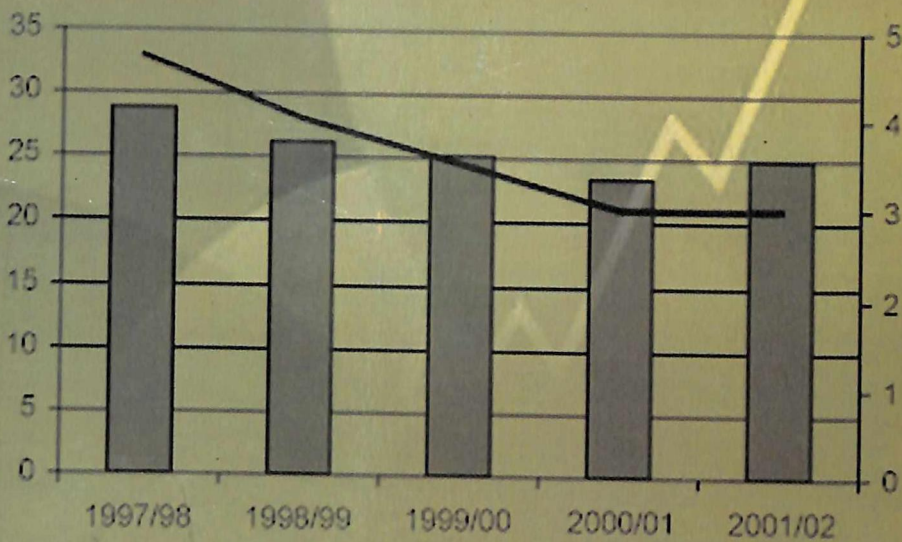
have also carried out a brief analysis of the growth of public expenditure consequent upon the growth of Gross State Domestic Product in order to ascertain its degree of variation with respect to states' income. It may be mentioned here that for the purpose of inter state comparison within the North-Eastern region, we thought it imperative to take two representative states, namely Meghalaya and Nagaland to ascertain the intricacies of of public expenditure growth in the North-Eastern States. The reason for choosing these two states is one fold. It is observed that in recent years, the state of Meghalaya has preferred to maintain a surplus budget while that of the state of Nagaland continues to have a deficit budget over the years. Thus, we believe that inter state comparison between these two representative states may throw some light on the resultant patterns of its utilization in other different states of North-Eastern region.

An estimation of elasticity and buoyancy of the state tax system as a whole is carried out in Chapter-V., and, in Chapter -VI, we present the policy implications.

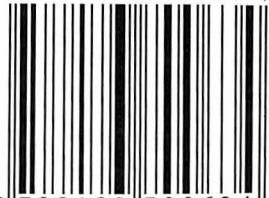
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ISBN 81-8370-063-2



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