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BA Economics Honours | Semester 3 | Calicut University

Tax Policy in India

Course Code: ECO3MN201 • Module 1

Module I: Introduction to Tax System in India

Tax policy is the primary instrument of sovereign statecraft, shaping capital accumulation, resource allocation, income distribution, and macroeconomic stability. In a federal emerging economy like India, tax policy must balance the imperative of mobilizing fiscal resources to finance massive public infrastructure and social development against the necessity of preserving private investment incentives and economic efficiency.

Unit 1 & 2: History and Objectives of the Indian Tax System

The philosophical and institutional foundations of taxation in India possess deep historical roots. In the ancient treatise *Arthashastra*, Kautilya articulated the classic cannon of fiscal statecraft: *"A king should collect taxes from his people just as a bee collects honey from flowers without harming them."* Taxes were levied on agricultural harvest, trade commodities, and mining output to maintain civil security and irrigation works.

Under British colonial administration, modern income taxation was enacted in 1860 by James Wilson to bridge the fiscal deficit resulting from the 1857 rebellion. Post-independence, tax policy was restructured across landmark reform epochs: the **Nicholas Kaldor Tax Reform Proposals (1956)** advocating an integrated direct tax system (including expenditure and wealth taxes); the **Direct Taxes Enquiry Committee (Wanchoo Committee, 1971)**; the **Tax Reforms Committee (Raja Chelliah Committee, 1991–1993)**, which laid the foundational blueprint for modern tax rationalization (slashing exorbitant marginal tax rates, broadening the tax base, and introducing simplified compliance); and the **Vijay Kelkar Task Force Reports (2002/2004)** recommending the introduction of a national Goods and Services Tax (GST).

Core Objectives of the Indian Tax System

1. **Mobilization of Fiscal Revenue:** Generating adequate, predictable revenues to finance sovereign administrative services, national defense, and developmental public investments. India's overall tax-to-GDP ratio hovers around ~17%–18% (combining Centre and States), which is significantly lower than the OECD average (> 33%) and emerging peers like Brazil (> 30%).
2. **Reduction of Income and Wealth Inequality:** Deploying progressive direct tax rates and wealth redistribution mechanisms to fulfill the Directive Principles of State Policy (Article 39(b) and (c) of the Constitution).
3. **Stimulating Private Capital Formation and Economic Growth:** Utilizing targeted tax incentives, accelerated depreciation allowances, and competitive corporate tax rates to foster domestic manufacturing and attract Foreign Direct Investment (FDI).
4. **Promoting Balanced Regional Development:** Historical deployment of tax holidays and fiscal concessions to incentivize industrial investments in backward, hilly, and northeastern states.
5. **Macroeconomic Counter-Cyclical Stabilization:** Adjusting excise and customs duties on volatile global commodities (crude petroleum, edible oils) to insulate domestic consumers from imported inflation.

Unit 3 & 4: Direct versus Indirect Taxes and Constitutional Division of Taxing Powers

The Indian tax structure is characterized by a structural reliance on indirect taxes:

- **Direct Taxes:** Taxes levied on income and wealth (Personal Income Tax, Corporate Income Tax, Capital Gains Tax), where impact and incidence fall on the same person. Direct taxes are inherently progressive, non-shiftable, and foster citizen civic consciousness, but suffer from narrow tax bases and administrative compliance challenges in developing economies.
- **Indirect Taxes:** Taxes levied on goods and services (GST, Customs Duties, Excise on petroleum), where impact falls on the seller and incidence is shifted forward to the final consumer. Indirect taxes are convenient, difficult to evade, and yield massive revenues, but are inherently regressive unless essential food items are exempted.

Constitutional Assignment of Taxing Powers (Seventh Schedule)

The Constitution of India demarcates sovereign taxing powers across three lists in the Seventh Schedule to prevent jurisdictional conflicts:

Constitutional Jurisdiction	Constitutional Entries	Major Tax Heads Assigned
Union List (List I)	Entries 82 to 92C	Taxes on income other than agricultural income; Corporate tax; Customs duties; Central excise on petroleum products and tobacco; Integrated GST (IGST).
State List (List II)	Entries 45 to 63	Land revenue; Taxes on agricultural income; State excise on alcoholic liquor for human consumption; State VAT on petroleum products; Stamp duty and registration fees; Motor vehicle tax.
Concurrent Taxing Power	Article 246A (101st Amendment)	Goods and Services Tax (CGST and SGST) levied concurrently by Parliament and State Legislatures.
Local Bodies (73rd & 74th Amendments)	State Enactments	Property tax, municipal water charges, local trade licensing fees.

Because the Union Government is assigned the most buoyant and elastic tax bases (direct income and corporate taxes) while State Governments bear primary constitutional expenditure responsibilities (education, public health, agriculture, law and order), a severe **Vertical Fiscal Imbalance** exists. This is rebalanced quinquennially by the constitutional **Finance Commission (Article 280)**, which awards statutory tax devolution (currently 41% of net divisible Union tax proceeds under the 15th Finance Commission chaired by N.K. Singh).

Advanced Theoretical Formulations and Empirical Frameworks (Analytical Division 1)

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Empirical Methodology, Identification Strategies, and Econometric Estimation

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Consider the structural estimation of policy impacts across decentralized economic agents. When evaluating macroeconomic interventions or microeconomic regulatory changes, parameters estimated from observational datasets must account for expectations formation and structural parameter stability in accordance with the Lucas Critique. Consequently, contemporary applied economics bridges micro-foundations with aggregate macroeconomic phenomena through dynamic stochastic general equilibrium (DSGE) modeling and micro-econometric panel estimations.

Comparative Institutional Analysis, Market Failures, and Policy Governance

Economic outcomes are fundamentally mediated by institutional architectures, legal property rights regimes, and regulatory governance. In emerging market economies such as India, market imperfections—including asymmetric information, transaction costs, infrastructural bottlenecks, and credit constraints—often necessitate nuanced policy interventions that differ substantially from textbook laissez-faire predictions.

Analytical Dimension	Orthodox / Classical Perspective	Heterodox / Institutional Framework	Empirical Policy Manifestations in India
Market Efficiency	Markets clear instantaneously; price mechanism allocates resources optimally without systemic friction.	Markets are prone to structural failures, information asymmetry, and coordination coordination failures.	Targeted regulatory oversight, public investment in infrastructure, and social safety nets.
Behavioral Motivation	Hyper-rational agents maximizing expected utility with complete cognitive computational capacity.	Bounded rationality, behavioral heuristics, loss aversion, and institutional anchoring effects.	Choice architecture, behavioral nudges (NITI Aayog initiatives), and consumer financial protection mandates.
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Technological Progress	Exogenous technological shocks arriving randomly (Solow neoclassical growth model).	Endogenous technological innovation driven by R&D, human capital, and intellectual property institutions.	National Innovation Foundation, Startup India, and public digital infrastructure (India Stack / UPI).

Comprehensive Empirical Analysis: The Kerala Model and Sub-National Development

In the context of the Indian economy and sub-national development paradigms, the Kerala Model of Development provides a seminal empirical case study illustrating the complex trade-offs between social development and economic growth. Characterized by high physical quality of life indicators—including near-universal adult literacy, high life expectancy, and low infant mortality rates comparable to advanced Western economies—achieved despite historically modest per capita state domestic product, Kerala demonstrates the transformative power of public social expenditure, agrarian land reforms, and decentralized local governance (Panchayati Raj institutions).

However, contemporary economic analysis also highlights structural challenges confronting this development paradigm: high educated unemployment, fiscal constraints stemming from escalating public debt servicing and pension obligations, and heavy reliance on external remittance inflows from migrant workers in the Persian Gulf. Sustaining this high-welfare equilibrium necessitates transitioning toward a knowledge-driven economy, incentivizing high-tech manufacturing, and mobilizing sustainable sub-national fiscal resources.

Policy Synthesis and Analytical Evaluation

Policy formulation in dynamic economic environments must therefore synthesize foundational deductive reasoning with robust inductive empirical inquiry. Economists must continuously evaluate the balance between market incentives and regulatory governance, ensuring that institutional frameworks promote both productive efficiency and distributive social justice.

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