

### 1. Taxation

Taxation is the compulsory contribution levied by the government on individuals, businesses, and other entities to fund public expenditure. It is a sovereign power of the state to impose taxes for meeting common needs like infrastructure, defence, education, and welfare.



### Objectives of Taxation

- **Revenue Generation:** Primary objective; taxes provide the bulk of government revenue for public services and development.
- **Redistribution of Income:** Through progressive taxation, wealth is transferred from higher-income groups to lower via subsidies and welfare schemes, reducing inequality.
- **Economic Stability:** Taxes act as automatic stabilisers (e.g., higher taxes during booms reduce inflation) and tools for fiscal policy to counter recessions.
- **Resource Allocation:** Taxes discourage harmful activities (e.g., sin taxes on tobacco) and encourage desirable ones (e.g., subsidies/exemptions for renewables), guiding efficient resource use.

### Canons of Taxation (Adam Smith)

**Adam Smith's four canons remain foundational:**

1. **Equity:** Taxes should be based on the ability to pay (progressive nature).
2. **Certainty:** Tax amount, time, and method should be clear and predictable.
3. **Convenience:** Payment should be easy and at a convenient time.
4. **Economy:** Cost of collection should be minimal relative to revenue. Additional modern canons include productivity, elasticity, flexibility, and simplicity.

# Tax Base & Tax Rate

## 1. Tax Base: The "What" of Taxation

The Tax Base is the total value of assets, income, or economic activity that a government is legally allowed to tax. It is the "foundation" upon which the tax is calculated.

### Types of Tax Bases

- **Income Base:** Salaries, business profits, dividends, and interest (e.g., Personal Income Tax).
- **Consumption Base:** Spending on goods and services (e.g., GST, Excise Duty).
- **Wealth/Asset Base:** Value of property or capital (e.g., Property Tax, Capital Gains Tax).
- **How to Broaden?**
  1. **Formalisation:** Bringing the informal sector into the formal economy (GST has been a major tool here).
  2. **Reducing Exemptions:** Phasing out specific tax holidays or deductions
  3. **Technology:** Using AI and data analytics (e.g., Project Insight) to track high-value transactions and catch non-filers.
  4. **Taxing the "Missing Middle":** Identifying professionals (doctors, lawyers) and small businesses that operate in cash.

## 2. Tax Rate: The "How Much" of Taxation

The Tax Rate is the percentage or specific amount applied to the tax base to determine the final tax liability.

### Types of Rates

- **Statutory/Nominal Rate:** The rate prescribed by the law (e.g., the 30% slab in income tax).
- **Effective Tax Rate:** The actual percentage paid after considering deductions, exemptions, and surcharges.  
**Formula:** Effective Rate =  $\text{Formula: } (\text{Total Tax Paid} \div \text{Taxable Income}) \times 100$
- **Specific Rate:** Tax levied per unit of a product (e.g., ₹10 per litre of petrol).
- **Ad Valorem Rate:** Tax levied as a percentage of the value (e.g., 18% GST on a laptop).

### Types of Taxation

- **Progressive:** Rate increases with income/base (e.g., income tax slabs); promotes equity.
- **Proportional:** Fixed rate regardless of base (e.g., flat tax); neutral impact.
- **Regressive:** Rate decreases as base increases (e.g., higher burden on the poor via indirect taxes); often criticised for inequity.

## 2. Classification of Taxes

### Direct Taxes

Levied directly on the income/wealth of persons/entities; burden cannot be shifted; based on ability to pay; progressive in nature.

## Examples:

- Income Tax (on individuals/HUFs).
- Corporate Tax (on companies).
- Capital Gains Tax (on profits from asset sales)
- **Advantages:** Promotes equity; elastic (revenue rises with income); reduces inequality.
- **Limitations:** High evasion potential; compliance burden; discourages savings/investment if rates are too high.
- **Role in Equity & Redistribution:** Progressive slabs ensure higher contribution from the rich; funds for welfare schemes.

## Indirect Taxes

Levied on goods/services; burden can be shifted (e.g., seller to buyer); regressive; easy collection at source.

## Examples:

- GST (on supply of goods/services).
- Customs Duty (on imports).
- Excise Duty (limited to specific items like petroleum, tobacco post-GST).
- **Advantages:** Broad base; hard to evade; inflationary control via rates.
- **Limitations:** Regressive (hits the poor harder); cascading effect if not credited; inflationary if rates are high.
- **Inflationary Impact:** Higher indirect taxes increase prices, potentially fuelling inflation.

Direct Tax vs. Indirect Tax		
Characteristic	Direct Tax	Indirect Tax
Burden Shifting	Cannot be shifted	Can be shifted to consumer
Equity	Promotes social equity	Can be regressive
Evasion	High possibility	Low possibility
Inflation	Helps control inflation	Can cause inflation
Administrative Cost	Higher	Lower

## 3. Constitutional Provisions Related to Taxation

- **Article 265:** No tax shall be levied or collected except by authority of law (rule of law in taxation).
- **Seventh Schedule:** Divides taxing powers into
  1. **Union List (List I):** Income tax, corporate tax, customs, central GST, excise (limited).
  2. **State List (List II):** Land revenue, stamp duty, state GST, excise on alcohol.
  3. **Concurrent List (List III):** None for taxation post-GST.

- **Article 246:** Parliament has exclusive power over the Union List; states have over the State List.
- **Article 270:** Taxes levied/collected by the Union (except surcharges) are shared with states as per the Finance Commission recommendations.
- **Articles 268–269A:** Stamp duties (Union levies, states collect); GST framework (concurrent, but administered via GST Council).
- **Role of Finance Commission:** Recommends vertical (Centre–states) and horizontal (inter–state) devolution of taxes; grants-in-aid. Current (15th FC, extended): States' share 41% of divisible pool (2021–26).

## 4. Goods and Services Tax (GST)

The Goods and Services Tax (GST) is the most significant indirect tax reform in India since independence. For a UPSC aspirant, it is vital to understand not just the static components but also the "GST 2.0" reforms effective from late 2025.

### Rationale and Constitutional Foundation

- **Rationale:** To eliminate the cascading effect of taxes (tax on tax), create a unified national market, and shift from an origin-based to a destination-based consumption tax.
- **101st Constitutional Amendment Act (2016):**
  1. Inserted Article 246A, giving both Parliament and State Legislatures concurrent power to make laws with respect to GST.
  2. Subsumed nearly 17 indirect taxes (Excise, VAT, Service Tax, etc.).

### The GST Council (Article 279A)

The GST Council is a Constitutional Body that acts as the primary decision-maker for the GST regime.

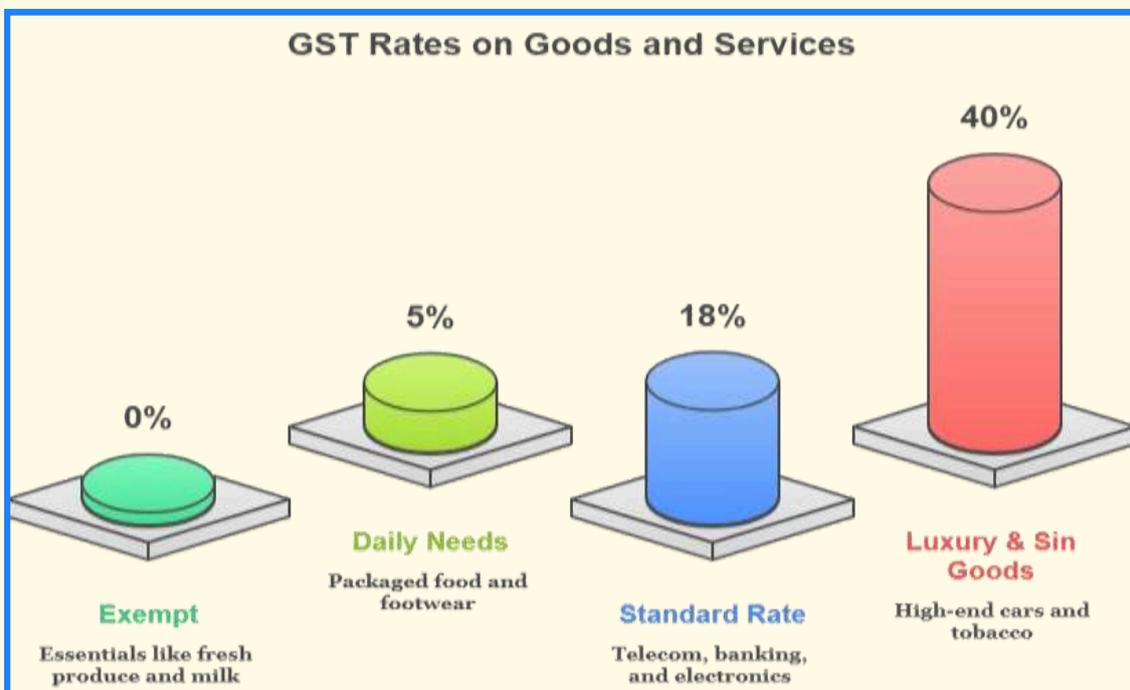
- **Composition:**
  1. **Chairperson:** Union Finance Minister.
  2. **Members:** Union Minister of State (Finance) and Finance Ministers of all States/UTs.
- **Voting Mechanism:**
  1. **Centre's Vote:** 1/3rd weightage.
  2. **States' Vote:** 2/3rd weightage.
  3. **Decision Majority:** 3/4th (75%) of the weighted votes of members present and voting. This ensures neither the Centre nor the States can take unilateral decisions, embodying Cooperative Federalism.

### Types of GST

- **CGST (Central GST):** Levied by the Centre on intra–state supply.
- **SGST/UTGST (State/Union Territory GST):** Levied by the State/UT on intra–state supply.
- **IGST (Integrated GST):** Levied and collected by the Centre on all inter–state supplies and imports. The revenue is later shared between the Centre and the destination State.

### GST Slabs: Transition to GST 2.0 (2025–26)

As of September 2025, the GST Council implemented "Next-Gen" reforms to simplify the structure into two primary slabs:



## Input Tax Credit (ITC)

ITC is the "soul" of GST. It allows a business to deduct the tax already paid on inputs from the tax payable on the final output.

- **Mechanism:** If a manufacturer pays ₹100 in tax on raw materials and ₹ 150 in tax on the final product, they pay only the balance of ₹50 to the government.
- **Benefit:** Prevents cascading and encourages businesses to get registered to claim credits, thereby increasing the tax base.

## GST Compensation & Recent Changes

- **Original Promise:** States were guaranteed a 14% annual revenue growth for 5 years (ending June 2022). Shortfalls were met via a Compensation Cess.
- **Extension:** Due to COVID-19, the Cess was extended to March 31, 2026, primarily to repay loans taken to cover the revenue gap.
- **End of Cess (2026):** Effective February 1, 2026, the GST Compensation Cess has been formally abolished for most items (including tobacco), as the loan obligations have been met. It is replaced by a new Health & National Security Cess on specific items like pan masala.

## 5. Tax Administration in India

- Central Board of Direct Taxes (CBDT): Administers direct taxes (income tax, corporate); policy formulation, oversight.
- Central Board of Indirect Taxes & Customs (CBIC): Handles GST, customs, excise; uses ADVAIT analytic suite.
- Faceless Assessment & Appeals: Introduced 2020; team-based, randomised allocation for transparency. E-Appeals Scheme (2023); mandatory virtual hearings if requested; aims to reduce harassment/litigation.
- Taxpayer Charter: Adopted 2020; commits to fair, transparent treatment; rights like privacy, timely refunds.
- Role of Technology (AI, Data Analytics): Project Insight (CBDT) for compliance monitoring; AI/ML for risk profiling, evasion detection (e.g., high-value transactions, crypto); big data for widening base; predictive analytics for refunds/scrutiny

## 6. Issues & Challenges in the Indian Tax System

- **Narrow Tax Base:** Low direct tax payers (~7-8% file returns); agricultural income exempt; large informal sector (~50% economy).
- **Tax Evasion & Avoidance:** Black money, fake invoices, underreporting; illicit outflows are high.
- **Informal Economy:** Limits formal taxation; hinders broadening the base.
- **Compliance Burden:** Multiple filings (despite reforms); MSMEs struggle.
- **Litigation & Disputes:** High pendency; faceless schemes aim to reduce, but delays persist.