सत्यमेव जयते

Report of the Task Force on

Implementation of the Fiscal Responsibility and Budget Management Act, 2003

July, 2004

Ministry of Finance
Government of India

Report of
Task Force on
Implementation of
the FRBM Act

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Preface

This Report on the Implementation of the Fiscal Responsibility and Budget Management Act, 2003, consists of seven chapters and associated appendices. The proposals outlined here are aimed to take our economy to a more commanding position to take full advantage from greater integration with the growing world economy and thus enable the country to achieve higher growth, greater employment opportunities, enhanced economic security and a more equitable economy.

Chapters 2 and 4 of the report discuss the background and macroeconomic issues relating to fiscal consolidation. Chapter 3 discusses the baseline scenario and its implications. Chapter 5 outlines the logic and the policy proposals, for tax as well as expenditure reforms, to achieve the required fiscal consolidation.

Among other things, this chapter contains proposals relating to the integration of goods and services taxation and the sharing of service tax revenues with the States. These proposals are of vital importance in connection with the proposed State level VAT reforms and can possibly form a part of a 'grand bargain' between the Centre with the States towards rationalising all State taxes on goods and services. These reforms of State level taxation are central to the long-standing policy goal of India as a common market, and for obtaining international competitiveness of our firms.

Our proposals on expenditure reforms are essentially in the nature of a policy approach, and would require further discussion with the Planning Commission, administrative Ministries and other stakeholders, to work out a shared program for expenditure reforms.

Chapter 6 gives the details of the revenue and expenditure projections. Annexures A and B provide the "empirics" of the revenue projections. Annexure A gives estimates for the various parameters used in the revenue projections. Annexure B gives estimates for revenues from the integration of goods and services taxes. These have been prepared on the basis of data collected from the Centre for Monitoring Indian Economy (CMIE). The CMIE database covers over 200,000 firms, using their Annual Reports submitted to the Department of Company Affairs. This is perhaps the most comprehensive firm-level database available in India. These annexures provide part of the empirical foundation for the policy proposals, and revenue projections, shown in the report.

Chapter 7 discusses the economic impact of achieving FRBM targets - i.e. how meeting FRBM objectives through systematic modernisation of taxation and expenditure would give a very positive impulse to the economy in terms of promoting growth, employment, equity and development indicators such as health and education.

In preparing this report, we should acknowledge the outstanding contribution by Shri Arbind Modi, IRS (IT), Dr. Ajay Shah, Consultant, Shri Gautam Ray, JS (TRU), Shri Jayant Sinha, DS (Budget) and Shri V. S. Chauhan, DS (Budget). Without their dedication, diligence and commitment to the goals of FRBM, we would not have been able to bring such a comprehensive report in so short a time. The drafting of the report has been done by Shri Arbind Modi and Dr. Ajay Shah. We would like to place on record our deep appreciation and gratitude to them for their splendid work. We would also like to thank Shri Madhusudan Prasad, Convenor to the Task Force for his splendid contribution to the work of the Task Force. The Task Force would also like to place on record its appreciation of the support and assistance rendered by officials and staff of the Ministry of Finance. In particular, the secretarial assistance of S. Ravi, R. C. Anand, Santosh Gupta, and Jawahar Peswani are gratefully acknowledged.

The proposed reforms are indeed bold reforms, and we believe that these reforms, accompanied by other structural reforms, will take our economy on a path of sustained "high quality growth".

(Vijay Kelkar)
Chairman

D.C. Gupta 16/7/04
Member

Vineeta Rai 16/7/2004
Member

N.S. Sisodia 16/7
Member

D. Swarup 16/7 2004
Member

Ashok K. Lahiri 16/7/04
Member

New Delhi
16 July 2004

Constitution of Task Force

Chairman		
	Vijay L. Kelkar	Advisor to Minister of Finance
Members		
	D. C. Gupta	Finance Secretary
	Vineeta Rai	Revenue Secretary
	N. S. Sisodia	Secretary (Financial Sector)
	D. Swarup	Secretary (Budget & Expenditure)
	Ashok K. Lahiri	Chief Economic Advisor
Convenor		
	M. Prasad	Joint Secretary (FRBM)
Advisors		
	Ajay Shah	Consultant (Department of Economic Affairs)
	Arbind Modi	Officer on Special Duty to Advisor to Minister of Finance
	Jayant Sinha	Deputy Secretary (Budget)

Chapter 1

Executive summary

Backdrop

India has faced persistent fiscal problems for over a decade. The revenue expenditure of government has lagged below revenue receipts of government, giving large revenue deficits. Large revenue deficits have been a recurring feature, year after year. Despite energetic efforts by a series of governments, the revenue deficit worsened from 3.3 per cent of GDP in 1990-91 to 4.4 per cent of GDP in 2002-03 (see Chapter 2).

A government that has a revenue deficit is taking debt in order to finance current (revenue) expenses. This recurrent bond issuance has led to a substantial build-up of debt, and interest payments have risen to enormous proportions. In 2000-01 and 2001-02, more than half of the revenue receipts of the government were used up in merely paying interest on the accumulated debt. In the 2004-05 budget presented on 8 July, an enormous sum of Rs.129,500 crore is required to merely pay interest on this accumulated debt. If India had prudent fiscal policies, this expenditure could have found alternative uses.

The non-interest expenditures of government, which is the part where government has discretion and can choose what kinds of expenditure are desired, fell from 14.7 per cent of GDP in 1990-91 to 10.7 per cent of GDP in 2000-01, a sharp drop of 4 percentage points of GDP over a one-decade period. This reflects the 'crowding out' of the legitimate functions of government, in the face of these fiscal problems.

The experience of the last five years has been relatively benign, owing to the decline in interest rates which came about through lower inflation rates. However, interest rates in the next five years will not go down in the same manner that interest rates went down in the last five years. This aspect constitutes an additional sombre aspect of the difficult fiscal situation.

FRBM

The gravity of the situation, and a multi-year process of debate and discussion, led to a far-sighted response. All political parties voted in favour of the *Fiscal Responsibility and Budgetary Management Act, 2003* (see Section 2.6). This Act required that the revenue deficit should be eliminated by 2007-08. An amendment to this Act, which is part of the Finance Bill laid in Parliament on 8 July 2004, proposes to shift this date to 2008-09.

Under the amended Act, from 2008-09 onwards, government would continue to be able to issue bonds, within limits, but only to finance capital expenditure which creates assets. Taking on debt would not be permitted in order to finance recurring (revenue) expenditure.

The task of eliminating the revenue deficit by 2008-09 appears like a distant goal. However, Rules under the FRBM Act additionally require (among other things) that the revenue deficit must come down by 0.5 percentage points of GDP every year, that the fiscal deficit must come down by 0.3 percentage points of GDP every year, and that the fiscal deficit in 2008-09 must be below 3 per cent of GDP. Appendix C contains the full text of the FRBM Act and associated Rules. This report outlines the strategy of policy measures to achieve the targets by 2008-09 as proposed in the Finance Bill.

Medium-term fiscal planning process

In the traditional annual budgeting framework, each budget is viewed in isolation, and the horizon of planning consists of one year. The FRBM framework has enormously improved this budgeting process at several levels. At the level of annual budgets, minimum targets for fiscal consolidation are required for every year - such as an improvement in the revenue deficit of 0.5 percent of GDP and an improvement in the fiscal deficit of 0.3 percent of GDP.

The Act also requires that government has to embark on a new concept of medium-term fiscal planning. This greatly differs from the traditional annual budget process. A new kind of fiscal planning process is required, which looks beyond 2005-06 all the way to 2008-09, in order to achieve the targets, and in order to transparently communicate the medium-term fiscal strategy to the nation.

This report attempts to address this question of fiscal planning (see Chapter 3) in two systematic steps.

Step I. First, a set of 'baseline' projections were made, whereby a detailed forecasting effort was undertaken in order to estimate the broad contours of Central finances from 2005-06 to 2008-09. This effort necessarily involves approximations and judgment calls about an uncertain future. There can be legitimate differences about how the projections were made. However, it is crucial to fully articulate, in numerical detail, the outcomes which are expected to come about if present trends continue. The baseline projections are a powerful tool for policy analysis, even if they are not exact.

The principle adopted by the Task Force when building the baseline projections was to obtain a numerical outline of the future *assuming that the four years from 2005-06 till 2008-09 will prove to be similar to recent years in terms of progress on policy and administration.* The baseline projections do not assume that major new tax reforms will come about. But they do assume that the *pace* of improvement in policy and administration, which took place in recent years, will be replicated between 2005-06 and 2008-09. It is important to not interpret the baseline projections as reflecting fiscal outcomes if no progress is made.

Step II. The next step consists of devising policy proposals which close the gaps (if any) identified between the baseline projections and the requirements of the Act.

Engaging in policy analysis, and projections of alternative rates and policies, requires grappling with complex questions. The Task Force utilised an array of empirically grounded research in choosing between alternative policies, and making projections for their potential impact upon fiscal outcomes. This research harnessed four datasets: (a) time-series of tax revenues, (b) previously unpublished data about the composition of excise revenues, (c) a dataset of roughly 1 million records of filings for personal income tax, and (d) the CMIE database of 2,74,446 firms of India. Some of the empirical research which was used in this process is shown in Appendix A and B.

Baseline projections

Deficit projections for 2008-09 under the baseline scenario (Section 3.7), expressed as per cent of GDP, are:

Revenue deficit	1.66
Fiscal deficit	3.98

Accomplishing the goals of the FRBM requires finding ways to eliminate this projected revenue deficit in 2008-09. The gap of 1.66 per cent of GDP translates to Rs.51,540 crore in 2004-05. It, hence, constitutes a considerable challenge for public finance. At the same time, there is extensive international experience with the accomplishment of much larger fiscal corrections over the required time-period.

Macro perspective of fiscal consolidation

Sound proposals for tax and expenditure policy require macro thinking about the required fiscal consolidation (Chapter 4). The broad goal of macroeconomic policy is to find the most effective trajectory through which the FRBM goals can be achieved.

There are two main questions about the fiscal correction required by the FRBM: (a) The question of an early ("front-loaded") versus a late ("back-loaded") adjustment, and (b) The question of how adjustment should be shared between taxation and expenditure.

Several reasons indicate the desirability of a 'front-loaded fiscal consolidation' (i.e. fiscal reforms in 2005-06 instead of later):

- Swift and decisive actions would greatly strengthen the credibility of the country's economic policy making.
- India should harness the opportunity presented by the strong economic performance, being experienced in the domestic economy and the world economy, in order to achieve fiscal consolidation in this period.
- It is possible that the macroeconomic outlook might be more sombre at some point in the medium term. In that case, an early fiscal consolidation will create the fiscal space through which government can use fiscal policy as a balancing tool.
- An early fiscal consolidation will yield early fruits in terms of higher growth in investment and employment. These are desirable results which should be obtained as quickly as possible.
- Raising tax revenues helps state finances through the devolution of resources, and fuels GDP growth through bigger resource flows into aspects of governance, such as law and order and education, which take place at the State level. An early improvement in the central gross Tax/GDP ratio will swiftly ease the difficulties of state finances, and thus yield early benefits for the development process at the State level.
- There is an innate lag between *decisions* on fiscal reform and their full impact (Section 4.3.1). Decisions taken in 2005 will fully yield fruits in terms of higher GDP growth and sound

fiscal outcomes by 2006 and 2007. It is hence important to take *decisions* early about reforms in tax and expenditure policies, so as to benefit from the full impact of these decisions by 2008-09.

On the second question, there are a number of arguments favouring fiscal consolidation through higher tax revenues rather than reduction in expenditure:

- Raising tax revenues has a powerful side effect of strengthening State finances, while cutting central expenditure does not.
- Cutting expenditure would be contractionary for the macro-economy. Raising tax revenues is likely to be less contractionary.
- Tax reforms have an important side effect - other than yielding tax revenues: they also spur higher GDP growth by removing the existing distortions and misallocation of resources.

The Task Force hence adopted four principles for the strategy for fiscal consolidation:

I. Fiscal consolidation should be revenue-led.

II. Fiscal consolidation should be front-loaded.

III. Capital expenditure should be enhanced, to counter-balance the contractionary effects of the fiscal consolidation, but expenditures should be conditional on institutional reform to ensure that the expenditure is well utilised.

IV. The reforms efforts on revenue expenditure should be further intensified.

Strategy for tax reform

The Task Force adopted the following strategy for tax reforms (Section 5.2).

1. *Widening the tax base*. India has extensive experience with the difficulties associated with high rates, 'exemption raj', and pervasive tax avoidance efforts by firms and households. Expanding the tax base, rather than increasing rates, is hence the preferred strategy. This involves removing exemptions and broadening the scope of the tax system to bring within its fold economic activities which are presently exempted.

2. *Few rates; Low rates*. High tax rates distort economic decisions and fuel the deployment of resources into tax avoidance and tax evasion. A large number of rates of taxes generate problems of bracket creep, classification disputes, and political lobbying about rates. These arguments suggest that a rational tax system is one with very few rates and low rates.

   It is particularly important to have single rates in the area of indirect taxes. The Indian consumer is known to be remarkably sensitive to apparently small changes in relative prices. The goal of a rational tax system is to *empower households* to engage in undistorted decision making, driven by their own needs and preferences, and not decisions made in the Ministry of Finance.

3. *Enhancing equity of the tax system*. Reform of the tax system should further both vertical and horizontal equity.

4. *Shift to non-distortionary consumption taxes to increase efficiency in production and enhance international competitiveness of Indian goods and services*. A key idea of sound public finance is to shift the incidence of taxation upon consumption. Tariffs, excises and turnover taxes on domestic goods and services have cascading effects. The destination-based VAT on all goods and services is the best method of eliminating distortions and taxing consumption. Under this structure, all different stages of production and distribution can be interpreted as a mere tax pass-through, and the tax 'sticks' on final domestic consumption.

5. *Enhancing the neutrality between present consumption and future consumption*. At present, the tax system is neutral between consumption and savings. Consumers typically favour present consumption over future consumption. Hence, neutrality between consumption and savings tends to depress savings rates and investment. Tax reform should impart inter-

temporal neutrality in consumption.

6. *Enhancing neutrality of the tax system to the form of organisation*. Teams or groups of individuals can be organised in many different organisational structures, such as limited liability companies, associations, clubs, partnerships, limited liability partnerships, etc. The choice of organisational structure adopted by decision makers in the economy should be driven by efficiency considerations and not tax considerations.

7. *Enhancing the neutrality of the tax system to sources of finance*. The choice between debt and equity and between retention and distribution of profits should not be distorted by tax considerations.

8. *Establishing an effective and efficient compliance system*.Good tax policy cannot exist without good tax administration.A well executed tax administration will enhance transparency and integrity, thereby inspiring public confidence. This involves four elements:

    - Establishing a program for taxpayer service and education to promote voluntary compliance with tax obligations;
    - Making non-compliance risky for violators;
    - Simplifying compliance procedures to reduce transaction costs;
    - Using information technology and modern process engineering, capable of providing accurate, timely and sufficient information.

9. *Focus on buoyancy rather than immediate sources of tax revenue*.

    Tax revenues can always be increased by imposing ad-hoc taxes. For example, it is always possible to pick sectors with easy enforceability - such as telecom or banking or oil - and impose taxes on them. However, such an approach is not a long-term foundation for a sound tax system. Such ad-hoc taxes have been seen to induce deeper distortions in the economy, adversely affecting the growth of GDP through misallocation of resources, and setting the stage for new kinds of tax avoidance mechanisms.

    The reforms strategy of this report focuses on establishing an economically efficient, effective and equitable tax system which will facilitate voluntary compliance. The focus in this report is on raising tax revenues through higher GDP growth and increased tax buoyancy rather then ad hoc distortionary taxes.

Proposal: The *Goods and Services Tax* (GST)

The existing framework of taxation of goods and services may be summarised as follows. The central government levies tax on goods at the manufacturing level while the States levy tax on goods at the point of sale. Taxation of services on a limited scale began in 1994 only by the central government. The tax on goods and services by the Centre has gradually shifted towards a VAT-type regime, while taxation of goods at the State level has not.

The problems with the existing taxation of goods and services may be summarised as follows. The tax base is fragmented between the Centre and States. Services which make up half of GDP are not taxed appropriately. In many situations, the existing tax structure has cascading effects, where moving to a full VAT system has not yet taken place. These difficulties have led to substantial distortions, where the tax revenues from a few sectors are disproportionate, and the choice of production technologies and inputs in the country has become distorted. The existing flaws in tax policy have induced a malfunctioning tax administration.

These problems have manifested themselves in terms of a poor buoyancy of excise collections, which has led to a low Tax/GDP ratio. More importantly, this has been a factor leading to slow growth of the manufacturing sector, and employment, in the country.

The constitutional difficulties associated with the taxation of services have been addressed by the 88th amendment to the Constitution, which was passed in 2003. Traditionally, the Centre had powers to tax the manufacturing of goods. The 88th amendment has carried these powers forward to extend to all services, including the services of trading and retailing of goods. This amendment enables Parliament to formulate, by law, principles for (a) determining the modalities of levying the service tax by the central government, (b) collection of the proceeds by the centre and the states, and (c) sharing of the proceeds between the centre and the states.

As a consequence, fiscal planning for the Centre now innately involves decisions about the manner of sharing of the proceeds between the centre and the states. Analysing potential future tax revenues from services has to be accompanied by planning how those tax revenues will be shared with the states.

The major proposal of the Task Force is that the VAT principle should be comprehensively used to tax the consumption of almost all goods and services in the economy (see Section 5.3). There is a need for the Centre and the States to come to an agreement on this fundamental issue.

The Task Force proposes a 'grand bargain' whereby States will have the power to tax *all* services concurrently with the Centre. Consequently, both central and state government would exercise concurrent but independent jurisdiction over common or almost common tax bases extending over all goods and services, and in both cases, going upto the final consumer. At the same time, both Centre and States would be required – under the proposed grand bargain – to abide by the following principles:

1. The number of tax rates is proposed to be restricted to three *ad valorem* rates, in addition to the zero rate. The proposed rate structure is:

   (Per cent)

	Centre	State
Floor	6	4
Standard	12	8
Higher	20	14

   Under this proposal, the total tax burden on most goods – by Centre and States – would work out to 20 per cent. This compares favourably with the standard VAT rates seen in OECD countries.

   The standard central rate of 12 per cent, which is proposed here, is lower than the existing standard CENVAT rate of 16 per cent. This reduction is made possible in a revenue-neutral way owing to the broadening of the tax base.

2. Centre and States should agree on a commonality of exemption lists and threshold limits, and common lists for the levy of excise on goods with negative externalities such as petroleum.

3. The treatment of imports and exports should be fully integrated with this dual-GST system, where imports are charged a two-part levy representing the Central GST and the State GST.

4. The GST system should minimise the costs of compliance faced by the firms of India. Hence, the centre and states should synchronise their administrative procedures and IT infrastructure. This will also help facilitate the implementation of State VAT within existing deadlines.

5. In order to handle calculations and funds transfers to States, there is a need of a nationwide clearinghouse mechanism. The computation of the final liability should be based on the invoice credit method, whereby credit would be allowed for tax paid on all intermediate goods or services on the basis of the invoice issued by the supplier. The Centre and the States should

cooperate in establishing this clearinghouse in order to transfer funds accurately, without incurring complex administrative overheads or compliance costs.

6. The introduction of the GST at both Central and State levels should be accompanied by the *withdrawal of all cascading taxes* such as Octroi, Central Sales Tax, state level sales taxes, Entry tax, Stamp duties, Telecom license fees, turnover taxes, tax on consumption or sale of electricity, taxes on transportation of goods and passangers, etc. This removal of inefficient and distortionary taxes would constitute a major milestone for reforms in Indian public finance.

7. The Central Excise Act and the taxation of services by the Finance Act, 1994, will be subsumed under the central goods and services tax. This should be implemented through a legislation which may be named *Indian Goods and Services Act*. The States will need to simultaneously introduce corresponding legislation for taxation of goods and services which will subsume their existing State-level cascading taxes.

Under this proposed 'grand bargain', the States obtain revenues from taxation of services, and from access to GST on imports. More importantly, India would obtain the full efficiencies of a single national VAT, while retaining a federal structure.

This proposal would constitute a major milestone for the modernisation of India's indirect tax system. Detailed empirical analysis obtained by the Task Force (Appendix B) has revealed that this is likely to lead to additional gross tax revenues from taxation of goods and services of 2 percentage points of GDP in 2008-09. Of this, roughly 0.6 percent of GDP would be transferred to the States, assuming existing formulas for resource sharing. This increase in the Tax/GDP ratio is central to the plan proposed in this report for achieving the FRBM targets.

From 1986 onwards, indirect tax policy in India has been steadily progressing in the direction of the VAT principle. The proposal in the Budget Speech of 7 July 2004, to integrate the service tax with CENVAT in terms of tax credits on input purchases, is an important milestone on the path to a single national VAT. The Task Force sees the introduction of the GST, as outlined above, as the logical culmination of this twenty-year process of debate and policy making.

Proposals on customs duties

There is now a wide consensus on the direction of customs reforms in India, with a desire to reach ASEAN rates of customs, and to have the minimal rate dispersion. Towards this, the Task Force proposes a shift to a three-rate structure consisting of 5 per cent, 8 per cent and 10 per cent.

This will innately involve a certain loss of tax revenue. This loss has been fully integrated into the medium-term fiscal planning framework adopted by the Task Force.

Proposals on personal income tax

Reforms on personal income tax have been debated in India for over a decade. There is a broad consensus about the need to remove exemptions, rationalise incentives for savings, and to broad-base tax brackets.

Towards this goal, the Task Force recommends a *package* comprising:

- Removal of exemptions including those available under Sections 10A, 10B, 80IA and 80IB of the Income Tax Act. However, exemptions relating to housing loans, and those available to senior citizens and women will remain unchanged.

- Elimination of the standard deduction available to salaried taxpayers.
- Rationalising the savings incentives into a single 'EET' system, where contributions and accumulations are tax exempt, but the withdrawals are taxed as ordinary income. Savings of upto Rs.100,000 a year would be eligible for this deduction. Consequently, tax concessions such as those under Section 80L for interest income should be abolished.
- While the above proposals involve the removal of existing special clauses, all existing investments under schemes like PPF would be fully 'grandfathered'. That is, interest on existing deposits in these schemes would contine to be tax-exempt. However, new investments would be part of the EET system.
- A shift to the following two-rate schedule:

Income level (Rupees)	Marginal rate
Below 100,000	0
100,001 – 400,000	20
Above 400,000	30

A detailed empirical analysis of nearly 1,000,000 taxpayers has revealed that the above proposals - as a package - yield lower effective average tax rates for all categorires of taxpayers. At the same time, the proposals constitute a long-overdue rationalisation of personal income tax. Compliance costs would come down; higher tax buoyancy would be obtained; equity will be enhanced and the economy will benefit from reduced tax-distortions.

Detailed efforts in projecting the implications of this reform suggest that these changes - as a package - will lead to a loss of revenue at existing levels of compliance. However, the Task Force has used a variety of empirical research which suggests that these reforms will improve tax compliance, which would overcome this loss of revenue.

The report also has detailed proposals on modernising the tax treatment of fund management, zero coupon bonds, and 'speculative' transactions on financial derivatives.

Proposals on corporate income tax

The broad contours of reform on corporate income tax have been extensively debated in the last decade. The three main issues in reform are as follows. Depreciation rates need to be brought into alignment with the low inflation rates and low interest rates which now prevail in India. The structure of exemptions needs to be removed in the light of the reduction in tax rates over the last two decades. Finally, the gap between the peak rate for personal income tax and the corporate tax rate needs to be removed.

Reflecting this consensus, the Task Force has proposed two alternative packages, each of which is revenue positive. The first candidate package comprises:

1. All existing tax incentives to be 'grandfathered' for existing units, but removed for new units.
2. A reduction in the general depreciation rate from 25 per cent to 15 per cent.
3. A reduction in the corporate tax rate from 35.875 per cent to 30 per cent for domestic companies.

The second candidate package differs from the above in two major respects. It is proposed to eliminate the tax on distribution of dividends, while preserving exemption from income tax of dividends in the hands of the recipient. It is proposed to phase out incentives over a period of two years, instead of grandfathering them.

Proposals on tax administration

The Task Force has two major proposals on strengthening tax administration.

The first concerns the implementation of the GST system outlined above. The efficient implementation of a system of tax credits, and refund of GST embedded in exports, requires a sound IT system. The issues faced in the GST system are identical to those encountered in the handling of TDS in income tax administration. Hence, the Task Force recommends that the existing TIN and OLTAS systems, developed by CBDT, should be used for the implementation of the GST, both at the Centre and at States.

The second major issue concerns tax evasion. A fresh effort needs to be undertaken in 'risk-based assessment', in order to identify tax evaders while simultaneously having a taxpayer friendly system. Honest taxpayers should not suffer from suspicion and harassment. At the same time, elementary notions of justice require that wrongdoers are identified and tax evasion is penalised. The Task Force has proposed an IT-intensive system named *Risk Intelligence Network* (RIN) which would address these goals. This will be an effective instrument against tax evaders.

Expenditure reforms

The Ministry of Finance plays a supporting role on issues of expenditure. The bulk of expenditure takes place in various Ministries with oversight of the Planning Commission. Hence, the proposals of the Task Force on expenditure reforms are essentially in the nature of a policy approach, and would require further discussion with the Planning Commission, administrative Ministries and other stakeholders, to work out a shared program for expenditure reforms.

Government expenditures can play a profound role in the development process when they produce public goods, such as defence or law & order, where the consumption of the public good by an incremental citizen introduces no costs, and it is not possible to exclude any citizen from benefiting from the public goods. Some quasi-public goods, such as primary health and education services, are also well recognised as being the legitimate function of government.

The broad strategy for expenditure reforms may be summarised as comprising of four elements:

I. Public goods versus subsidies A greater portion of expenditure needs to be devoted to legitimate public goods, as opposed to transfers and subsidies. The plan versus non-plan or the capital versus revenue classifications need to be re-examined in this light.

II. Central versus local public goods In the spirit of the 74th amendment, resources that are used for the production of local public goods, such as water, sanitation, and primary education, should be transferred to Panchayati Raj institutions, who have better *incentives* to spend effectively, and have better *knowledge* about local preferences, local problems, and alternative production technologies.

III. Focus on public goods outcomes The public finance system in India has traditionally focused on *expenditure*. There is a need for a greater focus on public goods *outcomes*.

IV. Improvements in institutional mechanisms The *provision* of public goods can often be achieved more effectively through the use of the private sector in production. The role of public-private partnerships needs to be extended into a broader range of public goods.

These issues are sketched in greater detail in

Section 5.9.

Projections for the reforms scenario

Chapter 6 shows projections for outcomes that would obtain if the above reforms are carried out. These can be compared and contrasted with the outcomes that flow from traditional rates of progress, i.e. the 'baseline scenario', shown in Chapter 3.

The reforms scenario successfully delivers on all the requirements of the FRBM Act. In 2008-09, a revenue surplus of 0.15 per cent is projected. The fiscal deficit in 2008-09 is projected at 2.80 per cent of GDP.

The fraction of revenue receipts which are used up to merely pay interest is a major indicator of fiscal stress. That ratio is projected to be much lower in 2008-09, at 31.69 per cent under the reforms scenario, as compared with the value of 41.48 per cent under the baseline scenario. This portrays a sharp alleviation of fiscal stress.

The non-interest expenditure of government can be used for developmental purposes. Under the baseline scenario, it is projected to drop to 9.83 per cent of GDP by 2008-09. Under the reforms scenario, a value of 10.76 per cent of GDP is obtained, which gives the government much greater space to give an additional impetus to development by spending on the provision of public goods, such as law and order, judiciary, health, and education.

Transfers to states – states' share of net proceeds of taxes and duties, and non-plan transfers to states – are projected to stagnate at 3.3 per cent of GDP under the baseline scenario. Under the reforms scenario, they are projected to sharply go up to 4.4 per cent of GDP in 2008-09. In 2008-09, this projected incremental resource flow, of Rs.58,340 crore, would serve to greatly alleviate the fiscal stress in State governments. Along with larger plan expenditure for States, it is likely to bolster expenditures on public goods which are produced at the State level, such as law and order, judiciary, education, and health. State finances would also benefit by the major expansion of their tax base, under the proposals of this report, and by closely dovetailing State VAT with the architecture for implementation of the Goods and Services Tax that is proposed in this report.

Impact

The fiscal reforms proposed in this report would have enormously positive implications for India's outlook, going well beyond the narrow issue of achieving targets specified in the FRBM Act and associated rules.

A world class tax system. Implementation of the reforms proposed in this report would give India a world-class tax system. This would reduce costs of compliance, reduce tax evasion, and largely eliminate the distorted behaviour that comes from tax avoidance. The long-standing distortion of differential treatment of manufacturing and services would be removed. The reforms will enhance equity, since small firms and middle-class households bear the brunt of compliance costs and high tax rates.

Impact on investment. Public capital expenditure is projected to be higher by 0.6 per cent of GDP in 2008-09, when compared with the baseline scenario. This difference is a substantial sum, which is roughly twice the annual expenditure on NHDP. Private investment is also likely to go up, owing to improvements in tax policy, and the improved provision of public goods.

Impact on health and education. The bulk of expenditure on health and education takes place at the level of State governments. As argued above, the report proposes substantial addition of resource flows to States. Apart from State finances, the second source for resources into health and education is Plan expenditure. Plan expenditure is projected to be higher by roughly Rs.20,000 crore in 2008-09 under the reforms scenario.

Impact on manufacturing. The manufacturing sector is a potential source of crores of jobs in coming years. The central VAT on manufacturing is proposed to go down from 16 per cent to 12 per cent. The effective reduction of the burden on manufacturing will be greater, since they would also get tax credits for a full range of services consumed by them. Manufacturers will benefit from the full refund of the Goods and Services Tax embedded in their exports. Situations where Indian firms face negative rates of protection, with low customs duties, would be eliminated by the proposed reforms. The peak income tax on manufacturing firms would be lower. All these proposed reforms would bolster manufacturing and employment-intensive growth in the country.

Impact on exports. Indirect taxes in India have thus far been unfriendly to the central feature of global exports today, where production is broken down into specialised steps taking place at dispersed locations spread across the world. The reforms proposed in this report mean that India would be at par with China in terms of the indirect tax framework, with a system consisting of low customs duties, a nationwide Goods and Services Tax, and a full refund of the GST on all exports (see Figure 7.1). The introduction of this system in China in 1994 presaged the great boom in manufacturing exports from China, and will help do similarly in India.

The existing biases against export-oriented small and medium enterprises will be reversed by the proposed reforms (see Section 7.4). This will lead to a blossoming of agro-related and manufacturing exports from the country, which will generate a large number of jobs.

Impact on financial sector. The proposed tax reforms of this report reduce the average tax paid by finance companies. The EET tax system proposed in this report sets the stage for an enormous expansion of professional fund management. This will be assisted by the clarifications proposed in this report for the tax treatment of outsourced fund management of all kinds. Finally, the report proposes to modernise the tax treatment of derivatives transactions, which has been a major hindrance for the growth of sophisticated risk management in the country.

Impact on State finances. State governments are crucial to governance and development in the country. State finance would obtain an enormous boost, under the proposals of this report, through four channels:

1. The increase in Central gross tax revenues – of roughly 3 percentage points of GDP – would innately increase resource transfers to the States of roughly 1 percent of GDP.

2. States would benefit by the proposed extension of services as their tax base.

3. States would benefit by the proposed imposition of State VAT on imports, which would ac-

crue to them.

4. Higher plan expenditure will be associated with larger resource flows to States through states and UT plans.

These benefits are, however, a part of a 'grand bargain' between the Centre and the States, as outlined above, which does require States to coordinate their fiscal reforms with this shift to the GST.

Impact on defence expenditure. Under the baseline scenario, defence expenditure is expected to steadily drop from 2.4 per cent of GDP in 2001-02 to 1.9 per cent of GDP in 2008-09. The reforms proposed in this report halt this decline, and stabilise defence expenditure at 2.3 per cent of GDP.

Reduced crowding out. Under the reforms proposed in this report, the fiscal deficit in 2008-09 would be smaller by 1.2 percentage points when compared with the baseline scenario. This constitutes a reduction of the resource pre-emption by Government.

Impact on prices. The shift from the existing framework of indirect taxes to the GST, coupled with the reduction in import tariffs, is expected to have a small one-time negative effect on the prices of goods, and a small one-time positive effect on the prices of services (see Section 7.8).

Impact on growth and employment

All these envisioned implications of the reforms proposals of this report add up to a scenario where India is likely to experience a considerable acceleration in GDP growth, and deliver high quality growth. This will obviously also require associated reforms in other aspects of the economy to be undertaken at the same time.

The three major elements which will play a role, from a fiscal perspective, are:

- The first major factor is the *improved governance* made possible by easing the fiscal pressures upon government. This easing of resource constraints will greatly improve the quality and quantity of public goods and quasi public goods that are provided. The growth implications of improved public goods, such as the NHDP, is likely to be considerable.

- The second element lies in *removing tax-induced distortions*. The existing fiscal system has led to large-scale misallocation of resources. Tax reforms in India are likely to be expansionary through their impact on productivity. The behaviour of individuals and firms in India is greatly distorted by tax compulsions. In a simple, rational tax system, individuals and firms will make decisions based on economic principles, and considerations of efficiency and productivity, instead of being driven by tax planning.

- The third major factor is the issue of crowding out, i.e. the *pre-emption of financial savings by the government*. Tax reforms will free up greater resources for both equity and debt investment in the country. The fiscal consolidation will inspire confidence in the outlook for India, in the eyes of both domestic and foreign investors.

  In particular, the tax reforms proposed in this report will lower the cost of equity capital, and encourage entrepreneurship. They are consistent with a vision of investment-led growth for the coming five years.

It is projected that GDP growth would be faster under the reforms scenario, reversing the slow reduction in GDP growth that is expected to take place in the baseline scenario. In the terminal year alone, GDP is projected to be higher under the reforms scenario by Rs.1,42,000 crore. This would translate to significantly higher incomes and employment. Assuming a 60% labour share, an incremental Rs.85,200 crore of wage income would be injected into the economy in the year 2008-09 if fiscal reforms are taken up, which would impact on wages and employment.

There is an innate synergy between acceleration of GDP growth and fiscal consolidation, since taxes on a base of higher GDP are more easily able to pay off the existing debt. The goal of the reforms proposed in this report is to help harness a virtuous cycle of higher GDP growth, fiscal consolidation and fiscal reform, each of which strengthens the other.

On 8 July, the Finance Minister's budget speech eloquently said:

> *It is in our hands to shape our destiny. Progress is not always on a linear path, nor is it inevitable. If we bring thought and passion to our governance, and walk the path of honour and courage, we can make the future happen. And this century will be India's century.*

The reforms proposed in this report are not derived from linear and incremental changes on past trends. Their implementation is not inevitable, and will require sustained thought and passion on the part of Parliament and civil society. It is the deeply held view of the Task Force that their implementation will reshape our destiny, and take India to a commanding position in the world economy.

Chapter 2

The fiscal challenge

2.1 Fiscal deterioration

The fiscal problem in India has steadily built up from the early 1980s onwards. Figure 2.1 depicts this transition for the revenue deficit, i.e. the gap between revenue receipts and revenue expenditure.

In the early 1980s, there was actually a revenue *surplus* for the states, and for the consolidated accounts of the centre and the states. Both deteriorated sharply through the 1980s. There was a sharp runup of the deficit in the late 1980s, which ended with the BOP crisis of 1991. This was followed by efforts at fiscal caution until 1997, after which the central revenue deficit deteriorated sharply.

Figure 2.2 shows the corresponding information for the gross fiscal deficit. The gross fiscal deficit of the centre peaked in 1986, after which it has dropped. However, the gross fiscal deficit of the states, which was stable at roughly 2% of GDP to 3% of GDP until 1996, rose sharply thereafter. As a consequence, the consolidated deficit of the centre and the states has attained all time highs in the recent period.

This worsening of the deficit came about through a combination of weak tax revenues, a sharp increase in the wage bill, rising interest payments, and rising subsidies.

2.2 Evolution of Tax/GDP ratio

The Central Tax/GDP ratio, measured using central gross taxes, peaked at 10.6% in 1987-88. It dropped sharply to 8.8% of GDP in 1993-94 and to a low of 8.3% in 1998-99. From this level, it rose to 9.3% in 2003-04.

For the purpose of comparison, we focus on the 51 major countries of the world who have a PPP GDP above $100 billion. Figure 2.3 shows a graph of how the Tax/GDP ratio varies with GDP. India has one of the lowest levels of the Tax/GDP ratio in the world. This low Tax/GDP ratio has been a central feature of India's fiscal problem.

While India's fiscal system appears to have made little progress, when viewed through the Tax/GDP ratio, a great deal of qualitative progress has been made through tax reform, which has set the stage for a growth of the Tax/GDP ratio in a way that is consistent with rapid economic growth, and raising resources for financing public investment, producing public goods of adequate quality and quantity, and supporting enhanced spending on social programs in areas such as education and health.

Figure 2.1 Trends in revenue deficit

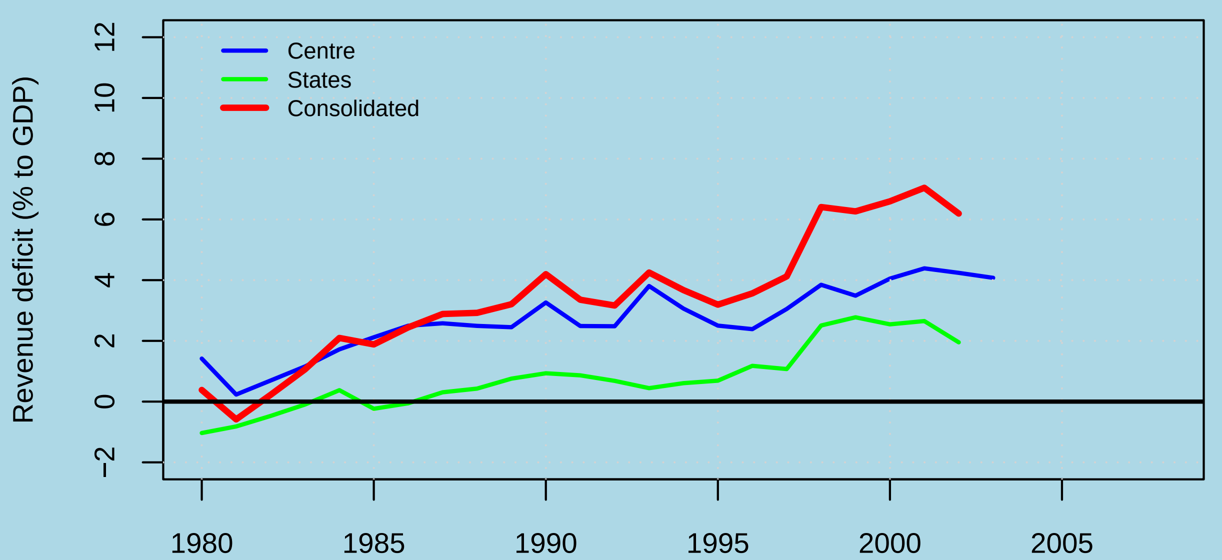
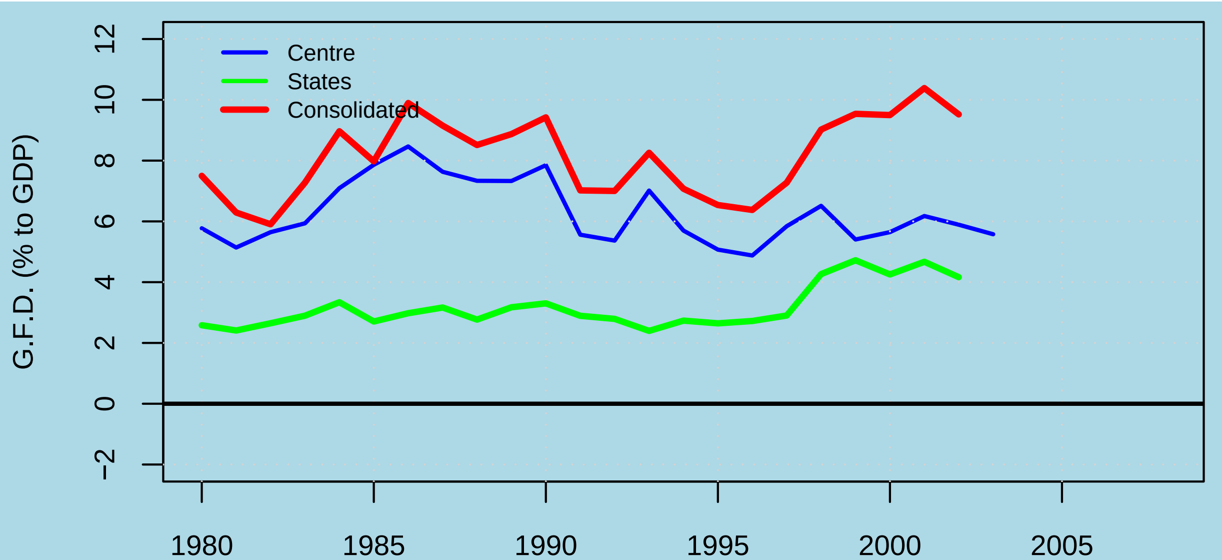


Figure 2.2 Trends in gross fiscal deficit



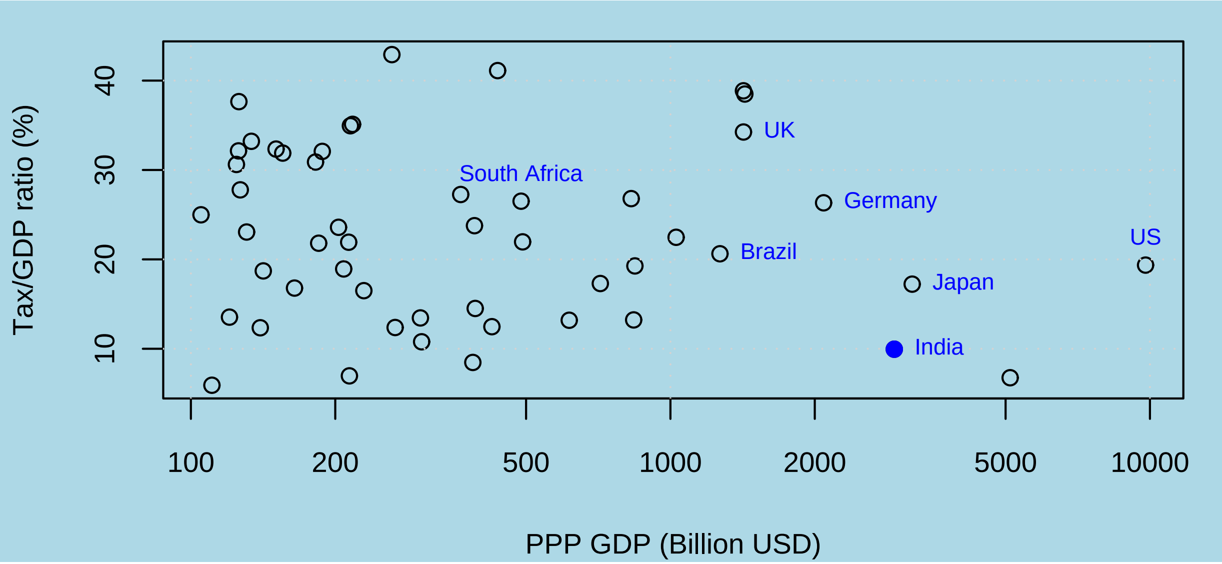
2.3 Diagnosing the poor performance on taxes

A sound diagnosis of the causes of the low Tax/GDP ratio, and of poor tax buoyancy (particularly in the case of excise) is a necessary precondition for emerging with policy proposals in terms of improvements in tax policy and administration.

This question has been extensively studied and debated in recent years. The key elements at work appear to be as follows:

Figure 2.3 Variation of Tax/GDP ratio with GDP (across 51 large countries)

Information for India in this cross-country dataset reflects only Central taxes. In many countries, the Tax/GDP ratio as commonly reported includes the taxes associated with social security.



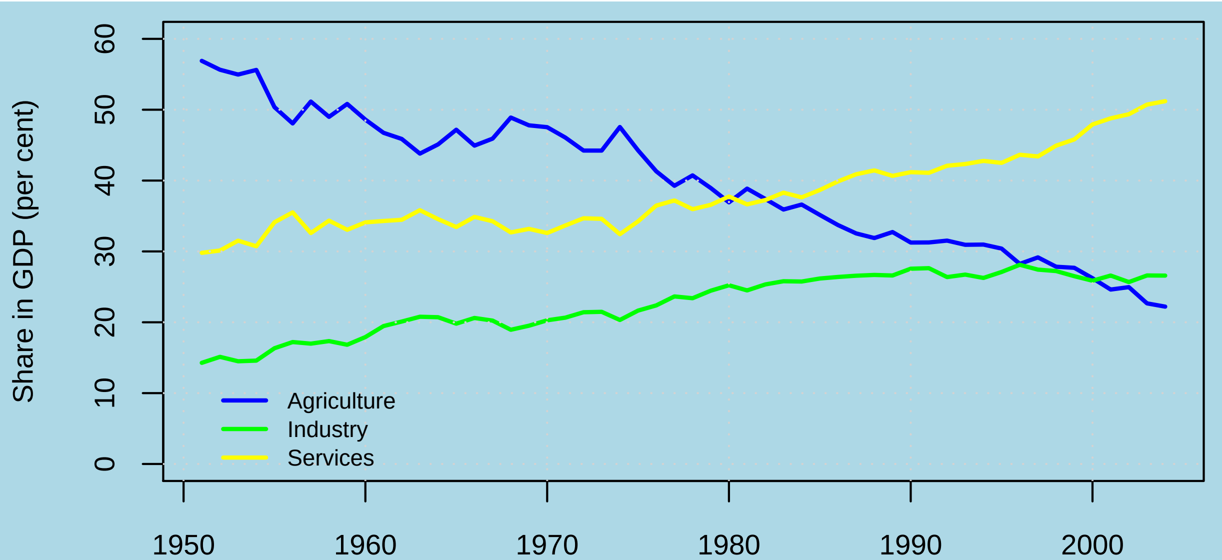
- The revenue base has been considerably diminished through exemptions.
- Manufacturing has been the focus of indirect taxation. The service sector is now larger than 50% of GDP. While taxation of services has commenced, the service tax accounts for less than 0.5% of GDP.
- Tax compliance is expensive, for honest citizens, and the probability of getting caught is low, for violators. This has led to an endemic culture of tax avoidance. India considerably lags the best international practice in exploiting information technology and new ideas in process design, in obtaining a frictionless and efficient tax administration which does not impose compliance costs upon honest citizens while faring well at spotting violators.

In public discussions, the main focus of diagnosing problems of the tax system has been on their impact on the tax-GDP ratio. However, an equally important dimension has been the *impact on GDP growth*. The pervasive structure of exemptions and special clauses in the tax code has distorted resource allocation and adversely affected GDP growth. Firms and individuals should make decisions based on efficiency considerations and not tax considerations. Every decision influenced by tax considerations is a suboptimal decision from the viewpoint of maximising India's economic development.

The present tax system is regressive, since the richest individuals and firms are able to harness the energies of tax consultants and lawyers, which are devoted on exploiting the complex tax system. Millions of man-hours of high-skill individuals are presently devoted to this quest. The move towards a simple tax system will give a more fair distribution of the tax burden in the economy.

Figure 2.4 Evolving structure of GDP

The share of agriculture in GDP rose from 43.8% of GDP in 1963 to 47.6% of GDP in 1974. From that point onwards, agriculture has steadily become a smaller part of GDP. The share of industry rose till the mid 1990s. From the mid 1980s onwards, the largest component of GDP has been services.



2.4 The composition of taxes

Figure 2.4 shows the familiar evidence about the evolving structure of India's GDP. The share of agriculture in GDP has dropped sharply, particularly in the period after 1974. From the mid 1980s onwards, services has been the largest single component of GDP. While the share of manufacturing grew in the early years, this expansion of the share of manufacturing has been halted in recent years.

Figure 2.5 juxtaposes the taxation of manufacturing with the evolving composition of GDP. In the early years, taxation of manufacturing was sharply escalated, to a point where excise accounted for over half of the central tax revenue. While this share has reduced, the share of excise in tax revenue continues to far exceed the share of manufacturing in GDP. While the services to GDP ratio is in the region of 50 per cent, the share of the service tax is below 0.5 per cent of GDP.

Figure 2.6 breaks down gross central tax collections into three components: Customs, taxation of goods and services, and Income tax applied upon both individuals and firms. The percentage contributed by each of these three is shown on the graph, and the three percentages add up to 100. The major tax reforms, which have taken place from 1987-88 onwards, are visibly manifested in this graph.

As recently as 1997-98, income tax was the smallest of these three components, where it made up just 26.7% of overall tax revenues. From this situation, we have a striking turnaround by 2003-04 (a period of just six years), where income tax was the largest of the three components. This reflects the

Figure 2.5 Evolution of GDP and tax composition

As this graph shows, in the early years after independence, taxation of manufacturing was sharply escalated, to a point in the early 1970s, where excise accounted for over half of the central tax revenue. Over the following years, the share of excise has declined to below 40 per cent, reflecting the processes of tax reform in the country. However, excise continues to contribute a disproportionate share of total tax revenues. In parallel, the services to GDP ratio has grown steadily to near 50 per cent. Services continue to contribute a negligible fraction of total tax revenue.

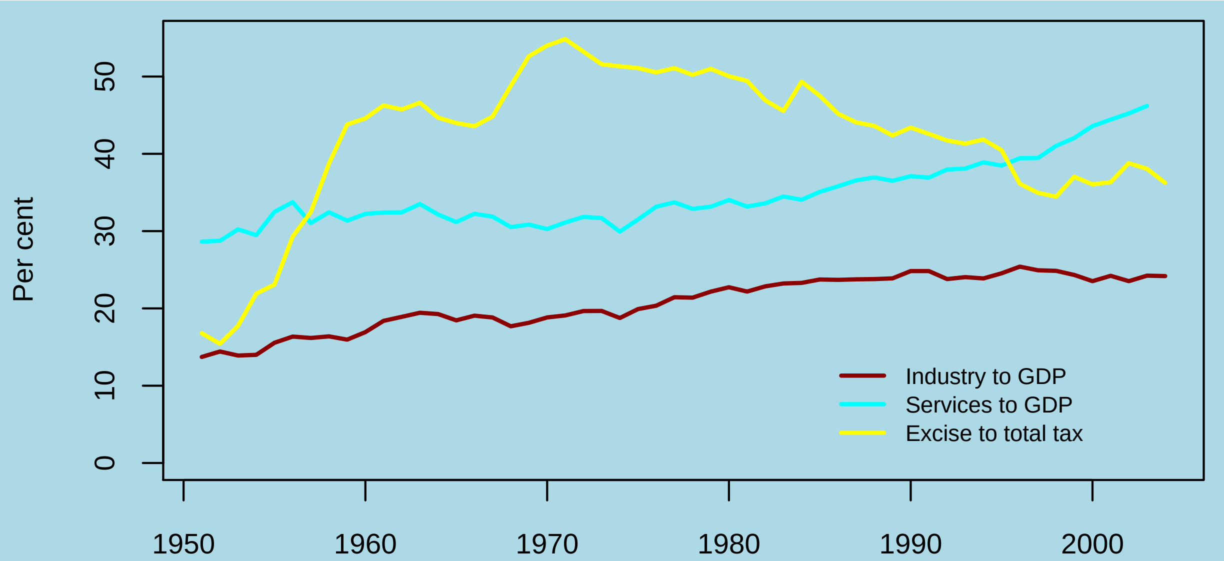
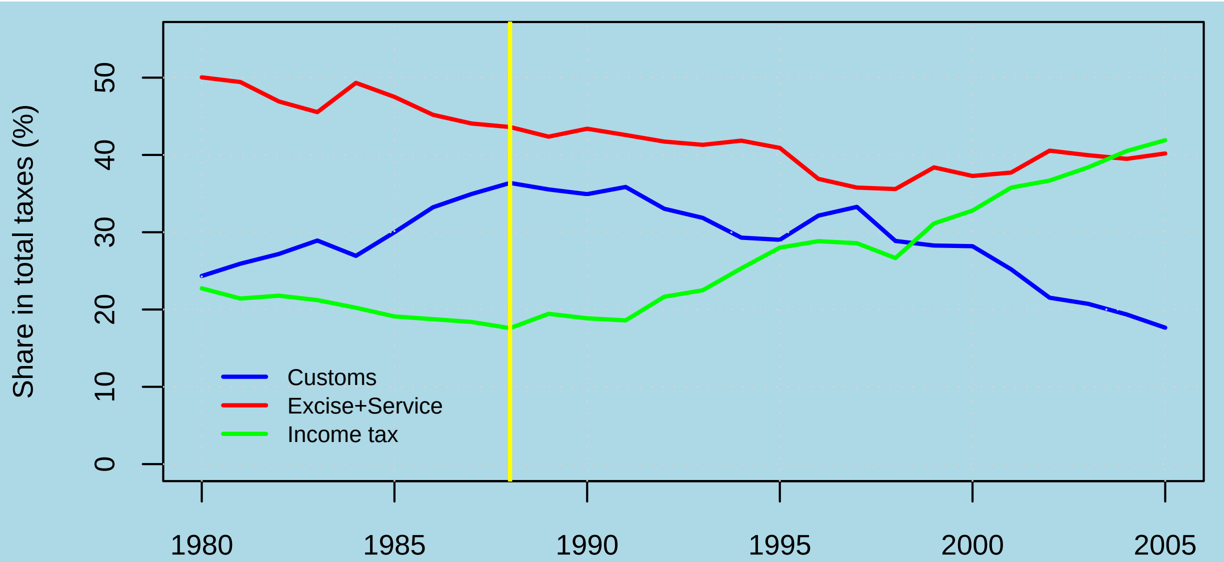


Figure 2.6 Evolution of tax composition (share in taxes)



important accomplishments of tax reform in this period.

It is interesting to observe that 1987-88, which was the year where the central Tax/GDP ratio peaked at 10.6%, was also the year where the proportion of customs tax revenues in the total tax collections peaked, at 36.4%, and the proportion of income tax collections was the lowest, at 17.6%.

Put together, excise and service tax - which reflect the taxation of goods and services - have stayed broadly constant from 43.6% in 1987-88 to 40.2% in 2004-05 BE.

Figure 2.7 re-expresses these same series as percentages to GDP, which is a particularly useful parametrisation when faced with medium-term fiscal planning.

Here also, 1987-88 stands out as the peak year of the traditional framework of tax policy, with a dependence on indirect taxes in general and on customs duties in particular. In that year, customs collections were 3.87% of GDP, excise was at 4.64% of GDP and income tax stood at 1.87% of GDP.

Compared with this starting point, sharp changes have come about. Customs duties have fallen to 1.79% of GDP. Excise has now been augmented by the service tax, and the combination yields 3.65% of GDP. Income tax has risen to a level of 3.75% of GDP. On income tax, the Tax/GDP ratio has risen steadily from 1991-92 onwards. In the case of excise and service tax, the poor performance of the Tax/GDP ratio appears to have bottomed out in 1998-99, where it dropped to 3.17%, and after that this ratio has risen to 3.65% of GDP in 2003-04.

2.4.1 The problem of customs

In the area of customs, the reforms process has obtained major progress in the period after 1991. As part of the removal of protectionist policies, and a move towards ASEAN levels of tariffs, there has been a sharp reduction in customs tariffs, and a consequent drop in the share of customs revenues. There has been a considerable effort on improving income tax collections, both for individuals and companies, through reduction of rates and rationalisation.

From 1987-88 onwards, the share of customs has consistently dropped, to a level of 17.6% in the 2004-05 BE, while income tax has risen sharply, from 17.6% in 1987-88 to 41.9% in 2004-05 BE.

In order to evaluate the international experience, Figure 2.8 shows the share of import duties as percent of total tax revenues in 2001, for the 51 countries with a PPP GDP of above $100 billion. In this group, India stands out as having an extremely high share, at roughly 20%.

If we exclude the four countries labelled on the map, the remaining 47 countries have an average of 3.83% of tax revenues coming from import duties. China, which has had great success with exporting, gets only 2.76% of its tax revenues from import duties.

The data above *overstates* the extent of customs tariffs in India, since they report the sum of customs and of CVD. CVD is, primarily in lieu of domestic production or consumption taxation. If India had a single VAT, then the CVD would be at this VAT rate. In other countries, the VAT that is charged on imported goods at the point of entry is shown as VAT revenue, and not customs

Figure 2.7 Evolution of tax composition (percent to GDP)

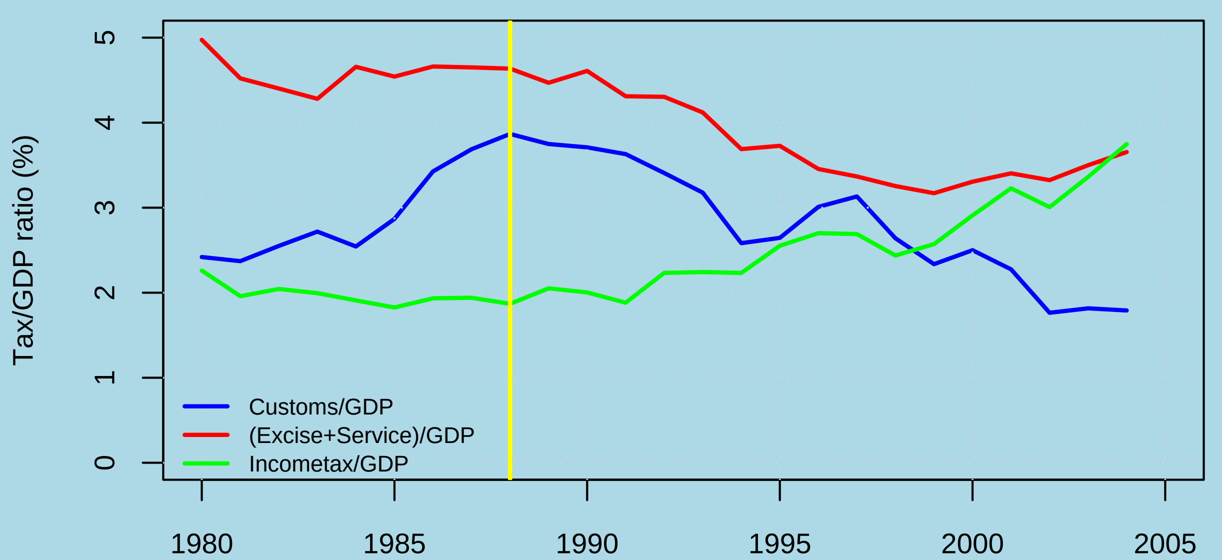
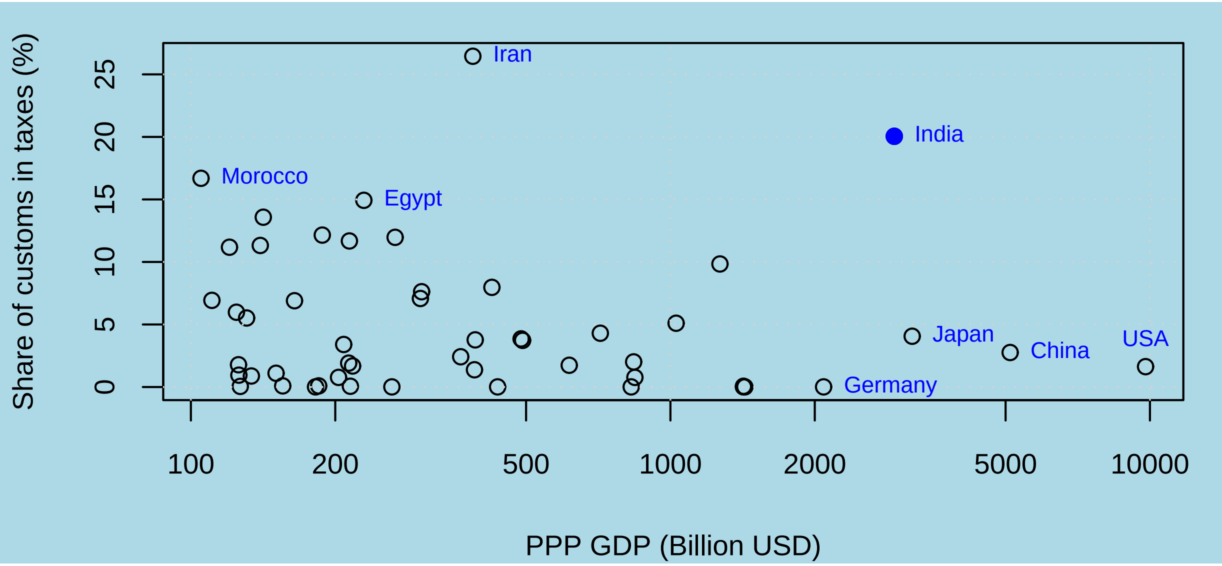


Figure 2.8 The share of import duties in taxes (across 51 large countries)

As emphasised in the text, Indian data for customs revenues are overstated to the extent that CVD on imports is conventionally classified as customs revenues. The normal international convention consists of classifying VAT on imports as VAT, and not as customs revenues. For this reason, the value seen for India here is overstated.



revenue. In India, this is conventionally lumped into customs, thus *overstating* the extent of taxation of imports.

As an example, in 2003-04 (RE), of the total customs collections of Rs.49,350 crore, collections on account of CVD (including

Table 2.1 Large countries with a high ratio of import duties to tax revenues (2001)

Rank	Country	Ratio
1	Iran	26.45
2	India	20.05
3	Morocco	16.69
4	Egypt	14.93
5	Chile	13.58
6	Algeria	12.15
7	Pakistan	11.97
8	Bangladesh	11.68
9	Venezuela	11.32
10	Peru	11.18
11	Brazil	9.84
12	Argentina	7.97
13	Colombia	7.62
14	Philippines	7.08
15	Nigeria	6.93

SAD) were Rs.20,451 crore, or 41 per cent. Similarly, in 2004-05 (BE), 35.7 per cent of the budgeted customs revenues come from CVD.

2.4.2 The problem of taxation of services

Inadequate taxation of services has been an important weakness of the tax system. The share of the services sector in GDP has grown sharply over time (see Figure 2.4). Yet, the focus of indirect taxes - through excise and customs - has been on manufacturing.

As of 2002-03, industry was 24.2 per cent of GDP, but excise tax collections were 38 per cent of central tax collections. Services were 46.2 per cent of GDP (Figure 2.4, Figure 2.5). Some of this anomalous taxation of manufacturing but not of services has been addressed by the introduction of the service tax. While service tax revenues have grown rapidly, service tax remains at unacceptable levels of below 0.5% of GDP.

Problems of allocative efficiency

The low tax rates prevalent for the fast-growing services sector have adversely affected the tax base. This has generated a bias in favour of higher tax rates on the manufacturing sector and on high import duties, in order to maintain the tax-GDP ratio. These high tax rates have adversely impacted compliance. By discriminating against the manufacturing sector, they have also adversely affected allocative efficiency.

At present, the bulk of indirect taxes is paid by consumers of goods and not services. The has tended to affect consumers' choice in favor of consumption of services. Further, the selective taxation of a few services that has come about through the 'service tax' has covered a small subset of the services sector, and distorted consumption of services in favor of untaxed services.

The Indian consumer is known to be remarkably sensitive to apparently small changes in relative prices. The goal of a rational tax system is to *empower households* to engage in undistorted decision making. Whether a household seeks to buy clothes or shoes or the services of a restaurant or a bank or a phone company: these decisions should be entirely cater to the needs and preferences of the household, without any distortions introduced by the tax system.

Problems of equity

The poor tend to consume necessities, with little value addition. The rich spend a larger fraction of their incomes on services. For example, the poor eat primary food and make do with simple clothing. The rich spend an ever-larger amount on the services of cooks (e.g. restaurants, processed food) and tailors (e.g. readymade clothes, designer clothes, personal tailors). Therefore, a symmetric tax framework covering the services sector is desirable from the viewpoint of both horizontal and vertical equity.

Problems of tax administration

The selective taxation of a few services innately causes definitional ambiguities, giving rise to classification disputes. When some services are taxed and some are not, there will always an attempt on the part of service provider to label their service as belonging to the non-taxable category. More importantly, the central VAT (CENVAT) only extends into manufacturing. Tax credits are not given for services purchased by manufacturers, or manufactures purchased by service producers. This serves to break VAT chains, distorts production through cascading taxation, and increases the likelihood of evasion.

2.4.3 Perspective on future improvements

There is a striking contrast between customs duties, and the other taxes, in terms of a perspective on tax reform.

In the area of customs, there was a time when shifting to a modern economic policy framework - i.e., without protectionism - was difficult since it would be associated with fiscal stress. For example, in 1987-88, customs tax revenues were as large as 36.4 per cent of Central tax collections, and reforms on customs duties were innately difficult. *That phase is now largely behind us*, since the customs revenues are now in the region of 17 per cent of tax collections. This figure is itself inflated - owing to the inclusion of CVD in customs. In addition, lower customs duties would be associated with a lower *outgo* for government on account of duty drawback.

Thus, the difficult part of customs reforms is now behind us, and further reductions in customs duties are now not difficult to obtain. When customs rates go down in the future, the fiscal cost will hence not be a serious problem since (a) The CVD portion of what is shown as customs revenues will be unaffected, (b) As rates go down, duty drawback payments will also go down. However, medium-term fiscal planning efforts do need to undertake special efforts in overcoming the loss of revenue from customs in the years to come.

In contrast, in the case of income tax and excise, the reforms that have been achieved so far have been the relatively easy ones, since they have primarily involved cutting rates, which is politically popular. Service tax was introduced in a simple manner, as an excise on a few services, without integration into VAT chains. The challenges that lie ahead are now the more difficult areas, such as removing exemptions, modernising tax policy in the area of excise and service tax, etc.

2.5 Major components of revenue expenditure

Two of the major components in revenue expenditure are interest payments and subsidies. These components of expenditure can meaningfully be expressed in two ways: as per cent to GDP, and as per cent to revenue receipts.

Table 2.2 Growth of interest and subsidies

	Percent to GDP		Percent to revenue receipts	
	Interest	Subsidies	Interest	Subsidies
1982-83	2.1	0.9	23.1	11.1
1992-93	4.2	1.4	41.9	14.6
2002-03	4.8	1.8	50.8	18.8

In the case of interest receipts, the steady growth of the Debt/GDP ratio has led to a corresponding growth in interest payments. In recent years, the decline in interest rates has masked the earlier trend of rapidly growing interest outgo.

In the case of subsidies, there are important problems of measurement. The elements of expenditure which are classified as a 'subsidy' in budget documents are only a subset of the overall subsidies. There are also many other expenditures which are actually subsidies, i.e. narrow transfers to a few households or firms, without any public goods characteristics. Hence, the size of subsidies as seen using the standard budget data substantially understates the actual extent to which the expenditures of government are being devoted to transfers/subsidies instead of being deployed on producing public goods.

Another area where subsidies exist but are not explicitly reported is the issue of 'tax expenditure'. One of the important reasons for the low Tax/GDP ratio is the erosion of the tax base through a large number of exemptions. Such exemptions are fiscally identical to subsidies. That is, *tax revenues foregone are no different from explicit subsidies paid out*.

As an example, if the government loses Rs.1,000 crore on account of the tax exemption of a certain 'small savings scheme', that is identical to a framework where the exemption did not exist, but explicit cheques of Rs.1,000 crore were written by government to those individuals.

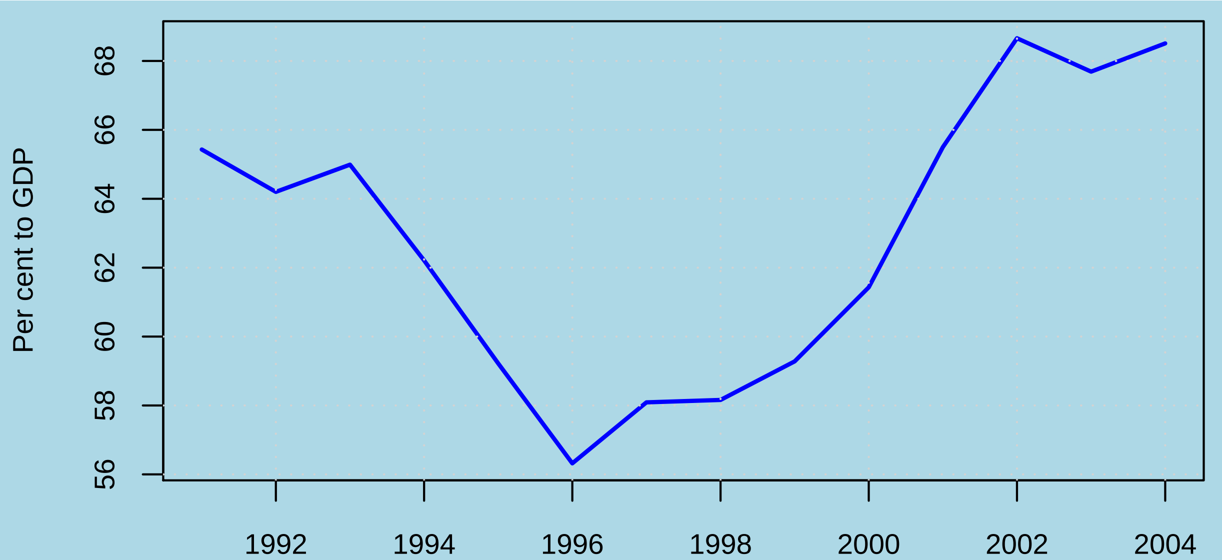
Table 2.2 summarises the experience with these components of expenditure over twenty years. In 1982-83, interest and subsidies added up to 34.2 per cent of revenue receipts. In 2002-03, this had doubled to 79.6 per cent. This has increasingly reduced the fiscal space available for the legitimate expenditures of government on the production of public goods. These numerical values understate the extent of this problem, to the extent that the full extent of subsidies is larger than portrayed by these statistics.

The essence of the challenge in terms of debt dynamics is the rising Interest/GDP ratio. This rose from 3.7 per cent of GDP in 1989-90 to 4.5 per cent of GDP in 1999-00. From this point onwards, interest payments have benefited from the sharp drop in interest rates, which has helped to contain the Interest/GDP ratio to 4.8 per cent in 2002-03. This sharp decline in interest rates is unlikely to be repeated in the future. Even under stable interest rates, in the absence of fiscal consolidation, the debt dynamics in the future could generate a higher Interest/GDP ratio.

2.6 FRBM

Figure 2.9 shows the evolution of the Debt/GDP ratio. While interest rates have fallen, and have generally been below

Figure 2.9 Historical Liabilities/GDP ratio



nominal GDP growth, persistent revenue deficits have been financed by new debt. This has led to an escalation of the Debt/GDP ratio. In particular, the fiscal deterioration has been particularly marked in the eight-year period from 1996-97 to 2004-05, where the Liabilities/GDP ratio worsened by 12.2 percentage points.

The persistent fiscal deficits, and the steadily growing Debt/GDP ratio, constitute the most important challenges affecting India's growth prospects. In response to this challenge, Parliament passed the Fiscal Responsibility and Budget Management (FRBM) Act, which was notified on August 26, 2003.[1] A central requirement of the FRBM concerns the revenue deficit in 2007-08: it requires that government undertake :

> "appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by 31st March 2008 and thereafter build up adequate revenue surplus"

The original FRBM Bill had proposed that the revenue deficit would be eliminated by 2005-06. The Act, as passed by Parliament, modified this to be 2007-08. On 8 July 2004, the Finance Minister announced that an amendment to the FRBM Act would be proposed to Parliament, which would further amend this date to 2008-09. This report defines its target as being the elimination of the revenue deficit by 2008-09.

The Central Government is required to fix annual targets indicating the path of adjustment, and required policy measures, so as to eliminate the revenue deficit. Table 2.3 summarises the requirements that were proposed by the FRBM Bill, that were

[1]The history of the FRBM may be summarised as follows. A committee headed by Dr. E. A. S. Sarma was setup in January 2000 in order to recommend draft legislation on fiscal responsibility. This report was submitted in July 2000. The bill was introduced in Parliament in December 2000, and enacted as law in August 2003, after a period of extensive discussion and analysis.

Table 2.3 Requirements of the FRBM

Requirement	FRBM Act	FRBM Rules
Revenue deficit		
Date for elimination	31/3/2008	
Min. annual gain		0.5% of GDP
Fiscal deficit to GDP		
Ceiling		3% by 31/3/2008
Min. annual gain		0.3% of GDP
Guarantees		
Max. annual issuance		0.5% of GDP
Total liabilities		Incremental flow capped at 9 per cent of GDP in 2004-05; this ceiling to be reduced by 1 percentage point of GDP every year.
RBI primary market purchases of GOI bonds	Cease on 1/4/2006	

enacted as the FRBM Act (2003), and are in the FRBM Rules (2004). The full text of the FRBM Act and the FRBM Rules is presented in Appendix C of this report.

A minimum annual reduction of 0.5 per cent of GDP in the revenue deficit, and 0.3 per cent of GDP in the fiscal deficit, is required by the FRBM Rules. This is a floor, and for a credible adjustment path, the actual correction will need to be higher in the years in which the correction takes place. The Rules also provide for an end-period target, namely that by March 31, 2008, the fiscal deficit will be below 3 per cent of GDP.

Additional liabilities assumed by the Central Government are required - under the FRBM Rules - to go down progressively by atleast one percentage point of GDP every year from a level of 9 per cent in 2004-05.

In addition, the FRBM embeds a series of improvements in the area of transparency and medium-term fiscal planning. It requires that three reports be placed before houses of Parliament every financial year:

Macroeconomic Framework Statement This report shows the underlying assessment of growth prospects, and the underlying assumptions. It defines the macroeconomic backdrop under which the fiscal policies and projections are being made.

Fiscal Policy Strategy Statement This report specifies the policy measures pertaining to taxation, expenditure, subsidies, administered prices and borrowing.

Medium-term Fiscal Policy Statement This report specifies three-year rolling targets for prescribed fiscal indicators, and the underlying assumptions.

The FRBM Act requires that the Finance Minister conduct quarterly reviews of receipts and expenditure, and place the outcome of these reviews before Parliament. He is required to make a statement in Parliament explaining the reasons for deviations from the FRBM Act obligations, and remedial measures that are proposed to be taken in order to overcome these.

Chapter 3

The baseline scenario and its implications

3.1 Process for medium term planning and projections

The medium term fiscal planning process undertaken in this report has been organised as two sets of projections: a 'baseline scenario' and a 'reforms scenario'.

To discuss the scale of new policy initiatives that are required for attaining the FRBM targets, the first step is the 'baseline scenario'. This consists of a portrayal of the outcomes that are likely to come about under conventional policies and trends.

The estimate of the revenue deficit in 2008-09 in the baseline scenario is a key foundation for thinking about what new efforts need to be made to overcome this gap. Towards this end, we seek to make projections from 2005-06 till 2008-09, for all major components of revenue receipts and revenue expenditures, so as to obtain an estimate of the revenue deficit in 2008-09 under the baseline scenario.

This magnitude guides the quest for policy proposals on revenue and expenditure, which could remove this gap. Projections are made till 2008-09 about the impact of these policy proposals. These projections are termed the 'reforms scenario'.

It should be emphasised that in any effort of medium-term fiscal planning and policy formulation, there are significant innate uncertainties about future events, and about the numerical consequences of alternative policy scenarios. Ex post, it will always be the case that reality diverges from these baseline estimates. At the same time, there is a need to form a 'best judgment' in fully articulated numerical terms, in order to envision the future and make sound decisions.

In this report, these have been done using a combination of empirical models, and the judgments of the committee. There will, innately, be many differences of opinion about the details of these projections. At the same time, there will also be a certain cancelling out of errors.

3.2 Interpretation of the baseline scenario

The baseline scenario reflects the outcomes that will obtain under 'business as usual', where the four years from 2005-06 till 2008-09 are similar to recent years in terms of progress on policy and administration.

The baseline scenario does *not* seek to portray the consequences of 'doing nothing', of freezing on policies and administration as of 2004-05. It captures the expected impact of *continuing to make progress on policies and administration at the rate that has prevailed in recent years*. Roughly speaking, such baseline projections for the next five years should be interpreted as the predictions for outcomes that would obtain if the *pace of reforms to policies and administration in the next five years was the same as that which came about in the last five years.*

This interpretation of the baseline scenario applies on both revenues and expenditures. In both cases, the projections for the baseline scenario assume conditions, and rates of change, comparable to those that have prevailed in recent years.

As befits any medium-term fiscal planning effort, a series of assumptions are required in pinning down the baseline scenario. They are documented in detail in this chapter.

3.3 Assumption about nominal GDP growth

One assumption that has a considerable impact on fiscal planning is that about nominal GDP growth. To the extent that we focus on fiscal consolidation expressed as per cent of GDP, errors in forecasting nominal GDP do tend to cancel out. However, there are other channels through which the nominal GDP assumption does affect the accuracy of projections.

Figure 3.1 shows the historical experience with nominal GDP growth, and the GDP deflator, from 1980 onwards. In the recent six years, the average nominal GDP growth has been 10.4%.

Table 3.1 Baseline GDP at market prices

(Rs. crore)

Year	GDP	Growth (%)
2003-04	27,72,194	
2004-05	31,04,857	12.00
2005-06	34,77,440	12.00
2006-07	38,86,039	11.75
2007-08	43,32,934	11.50
2008-09	48,20,389	11.25

Under the baseline scenario, which assumes that important fiscal reforms do not take place, it is expected that the revenue deficits would be large enough to yield a continually increasing Debt/GDP ratio. This is expected to have a deleterious effect upon growth in the medium term, through higher interest rates, crowding out of investment, poor credit rating, and lack of investor confidence. These would adversely affect GDP growth. Hence, the baseline scenario envisages a tapering off of GDP growth from current rates of 12 per cent per year to a rate of 11.25 per cent per year by 2008-09.

Table 3.1 shows the numerical values for projected nominal GDP obtained under this assumption. This shows that in 2004-05, each percentage point of GDP corresponds to about Rs.31,000 crore. This is expected to grow to about Rs.48,000 crore in 2008-09.

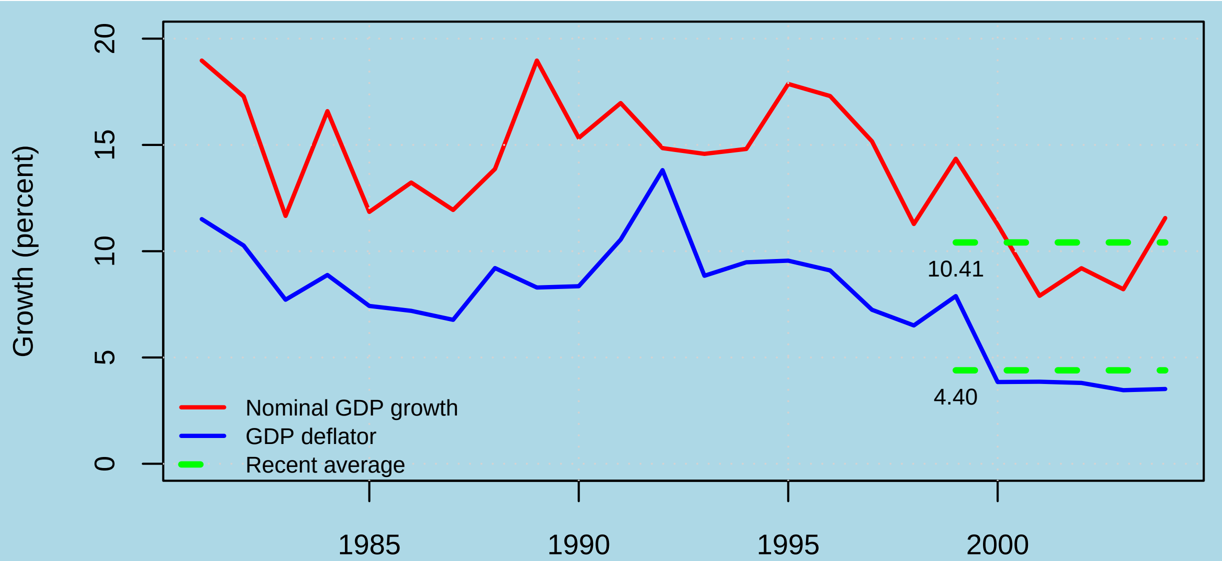
3.4 Baseline expenditure projections

Plan expenditure is projected to grow at the five-year historical growth rate, of 12.82%.

Defense expenditure is projected to grow at the five-year historical growth rate, of 8.73%.

Interest payment expenditures are projected based on the existing stock of debt, and an

Figure 3.1 Nominal GDP growth, and GDP deflator



assumption that the secondary market yield curve will stay at existing levels. The existing weighted average interest rate works out to 8.25% per annum. This is projected to drop as old securities mature, and new securities are issued at the lower interest rates which are now prevalent.

Projections for subsidies reflect the existing status of policy decisions about the removal of subsidies. The food subsidy is expected to grow at -5% per annum, thanks to better inventory management and lower interest rates. The fertiliser subsidy is expected to grow at the rate of 5% per year.

Other non-plan expenditure is expected to grow at the rate of 6% per year.

3.5 Baseline revenue projections

In each aspect of taxation, we need estimates of future tax buoyancies, i.e. the percentage change in tax revenues per unit percentage change in the tax base. For example, if we think of manufacturing GDP as the tax base of excise collections, then a buoyancy of 0.75 would imply that a 10% growth in nominal manufacturing GDP is expected to yield a 7.5% growth in excise collections.

These buoyancy estimates are critical to the baseline scenario. Empirical analysis, which provides the basis for the revenue projections in the baseline case, is presented in Appendix A.

Tax projections have been worked out based on historical trends of tax collections. The projections focus on the *trend* of growth in tax collections. There are always year-to-year fluctuations, owing to random factors, which take actual outcomes away from trends.

In the case of personal and corporate income tax, future tax projections assume that the recent experience with tax buoyancies will be repeated in the next four years.

Excise revenues are usefully classified into two components: Petroleum-Oil-Lubricants (POL) and non-POL. In the case of POL, it is assumed that the ratio of excise on POL to GDP will stay constant in the future. In the case of non-POL, it is assumed that the recent experience with tax buoyancy of roughly 0.5 will be repeated in the next four years.

In the case of customs duties, it is assumed that while GDP will grow at 12% nominal per annum, customs collections will only grow by 6% per annum. This is expected to come about through a combination of (a) reduction in tariffs with (b) growth in the import/GDP ratio. Under this framework, customs tariffs will drop to 15% of gross tax collection by 2008-09.

In the case of non-tax revenues, interest receipts are assumed to decline due to prepayment under the State Debt Swap scheme, pre-payment by Central PSUs and continuation of existing interest rates. It is assumed that dividends and profits paid by RBI and public sector corporations will drop by 5% per year.

Other non-tax receipts, including user charges, are projected to grow at the GDP rate; i.e. they are expected to have a buoyancy of 1.

It is assumed that devolution to states, of total gross tax collections, will take place using proportions that prevail today.

Table 3.2 summarises the baseline tax projections (in levels) and Table 3.3 re-expresses these values as per cent of GDP.

The projections imply considerable buoyancy (1.87) of direct tax. This is expected to yield a growth in the Tax/GDP ratio from 3.73% in 2003-04 to 5.76% in 2008-09.

The picture on indirect taxes is more sombre. Service tax is projected to have a buoyancy of 1 after 2004-05, and thus stay at 0.44% of GDP. The phasing out of protectionism, and a move towards ASEAN tariff levels, will lead to a drop in customs from 1.78% of GDP in 2003-04 to 1.41% of GDP in 2008-09. The poor buoyancy of non-POL excise in recent years is expected to give a drop in excise collections from 3.33% of GDP in 2003-04 to 2.92% in 2008-09. These addup to a drop in indirect tax collections from 5.47% of GDP in 2003-04 to 4.77% in 2008-09.

3.5.1 Non-tax revenue

Non-tax revenue forms an important constituent of revenue receipts of the Union Government. In the decade of nineties, non-tax revenue constituted between 24.1 per cent to 29.3 per cent of total revenue receipts of the Union Government. The principal components of non-tax revenue are interest receipts, dividends and profits, receipts from telecom sector and range of user charges levied by the Government. The interest receipts accrue to the Union Government from loans and advances made to State and Union Territory Governments, public sector companies, railways and others. Dividends primarily accrue to Government from payouts made by public sector companies and banks and dividends from RBI.

Table 3.4 shows the evolution of the components of non-tax revenue from 1990-91 to 2004-05. Interest receipts have steadily fallen in importance from 73 per cent to 52 per cent over this period. Dividend receipts have shown a significant increase, owing to the issue of guidelines on dividend payout, and now contribute over one-fifth of non-

Table 3.2 Baseline tax projections (Rs. crore)

This table shows tax projections, under the baseline scenario, expressed in crore rupees.

	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09	Growth 0405-0809	Buoyancy
Direct taxes	103,400	137,000	154,258	188,283	229,066	277,667	21.84	1.87
Income tax	40,269	50,009	58,458	69,842	83,299	99,000	19.71	1.68
Corporation tax	62,986	86,846	95,800	118,441	145,767	178,667	23.19	1.98
Indirect taxes	151,523	175,823	178,298	193,764	210,988	229,743	8.68	0.74
Excise	92,379	107,699	107,897	117,791	128,733	140,691	8.78	0.75
Customs	49,350	53,500	55,281	59,039	63,288	67,843	6.57	0.56
Service tax	8,300	14,000	15,120	16,934	18,967	21,244	20.68	1.77
Gross tax collection	254,923	312,823	332,556	382,047	440,054	507,410	14.76	1.26
Education cess	0	4,910	5,599	6,432	7,408	8,542		
Total gross taxes	254,923	317,733	338,155	388,479	447,463	515,952	15.03	1.28
GDP at market prices	27,72,194	31,04,857	34,77,440	38,86,039	43,32,934	48,20,389	11.70	

Table 3.3 Baseline tax projections: Per cent to GDP

This table shows tax projections under the baseline scenario, where all values are expressed as per cent to GDP.

(Per cent to GDP)

	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09
Direct taxes	3.73	4.41	4.44	4.85	5.29	5.76
Income tax	1.45	1.61	1.68	1.80	1.92	2.05
Corporation tax	2.27	2.80	2.75	3.05	3.36	3.71
Indirect taxes	5.47	5.66	5.13	4.99	4.87	4.77
Excise	3.33	3.47	3.10	3.03	2.97	2.92
Customs	1.78	1.72	1.59	1.52	1.46	1.41
Service tax	0.30	0.45	0.43	0.44	0.44	0.44
Gross tax collection	9.20	10.08	9.56	9.83	10.16	10.53
Education cess		0.16	0.16	0.17	0.17	0.18
Total gross taxes	9.20	10.23	9.72	10.00	10.33	10.70

Table 3.4 Evolution of sources of non-tax revenue

(Figures in Rs. crore; percentages in brackets)

	1990-91	1995-96	2000-01	2004-05
Interest Receipts	8,730	18,419	32,811	36,950
	(73)	(65)	(59)	(49)
Dividends	774	3,248	13,575	18,875
	(6)	(12)	(24)	(25)
Telecom Receipts	5	1,362	1,614	6,327
	(0)	(5)	(3)	(8)
Others	2,467	5,162	7,947	13,264
	(21)	(18)	(14)	(18)
Total	11,976	28,191	55,947	75,416

tax revenue. Insofar as telecom receipts are concerned, they have shown a sharp increase from a nominal amount of Rs.5 crore in 1990-91 to Rs.6,044 crore in 2004-05. These are primarily derived from revenue sharing arrangements with telecom service providers.

Over the next few years, interest receipts are expected to be sluggish in view of the softening interest rate regime. This aspect is reinforced by the States Debt Swap and pre-payment of Central loans. Dividend receipts are also expected to decline in view of the reduction in ownership by Government of public sector companies. In the case of user charges, realignment of these charges to cover cost may lead to additional non-tax receipts, but the benefit on this account is not expected to be considerable.

3.6 Projections about capital receipts

Projections about capital receipts are required in order to make projections about future interest payments, which are a function of the future evolution of the debt stock.

Non-debt capital receipts consist primarily of repayment of loans to the Union Government and receipts from disinvestment. Recovery of loans is projected to decline each year keeping in view the prepayment of loans by State Governments and PSUs. Disinvestment receipts have been assumed to be stable at the value chosen for 2004-05 BE, of Rs.4,000 crore per year.

3.7 Baseline projections and their interpretation

Using these assumptions, the baseline projections are shown in Table 3.5 (in levels) and Table 3.6 (percent to GDP).[1] The main features of these baseline estimates may be summarised as follows.

The baseline projections envisage a steady improvement in net tax revenues, from 6.77% to GDP (2003-04 RE) to 7.91% of GDP in the last year. At the same time, non-tax revenues are projected to drop to 1.51% of GDP. Putting these together, revenue receipts are projected to drop from 9.49% to GDP (2003-04 RE) to 9.42% of GDP in the last year.

Non-plan expenditure is expected to drop sharply, from 11.04% of GDP (2003-04 RE) to 8.84% of GDP in the terminal year. This reflects a combination of lower interest payments, a smaller expenditure on defence (as per cent of GDP) and smaller subsidies (as per cent of GDP).

The baseline assumptions are about envisaging ‘business as usual’, and hence they do not envisage reforms in plan expenditure, which is anticipated to marginally increase from 4.69 per cent of GDP in 2004-05 to 4.89 per cent of GDP by the end of the period.

Expressed in terms of revenue versus capital expenditures, capital expenditure is expected to be roughly stable, going from 2.34% of GDP (2003-04 RE) to 2.65% of GDP in the terminal year.

Figure 3.2 shows deficit projections under

[1]The provisional actuals for 2002-03 and the revised estimates for 2003-04 exclude transactions relating to repayment to NSSF under the Debt Swap Scheme.

Table 3.5 Fiscal projections under baseline scenario (Rs. crore)

This table shows fiscal projections under the baseline scenario, expressed in crore rupees.

(Rs. crore)

	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09
GDP	27,72,194	31,04,857	34,77,440	38,86,039	43,32,934	48,20,389
Gross tax revenue	254,923	317,733	338,155	388,479	447,463	515,952
Revenue receipts	263,027	309,322	323,538	360,480	404,021	454,202
Tax revenue, net to centre	187,539	233,906	248,990	286,659	330,787	381,418
Non-tax revenue	75,488	75,416	74,548	73,821	73,234	72,784
Capital receipts	164,626	168,507	189,891	199,719	203,130	207,909
Recoveries of loans	18,023	27,100	13,395	12,725	12,089	12,089
Other receipts	14,500	4,000	4,000	4,000	4,000	4,000
Borrowings and other liabilities	132,103	137,407	172,496	182,994	187,041	191,420
Total receipts	427,653	477,829	513,430	560,198	607,151	662,111
Non-plan expenditure	306,146	332,239	349,175	374,886	398,082	426,239
Interest, debt servicing	124,555	129,500	143,970	158,659	173,427	188,393
Defence	60,300	77,000	71,762	78,027	84,839	92,245
Subsidies	44,707	43,516	44,497	43,924	39,883	39,672
Grants, loans to States,UTs	15,850	19,576	21,181	22,450	23,797	25,225
Other non-plan expenditure	60,734	62,647	67,765	71,827	76,136	80,704
Plan expenditure	121,507	145,590	164,255	185,312	209,069	235,872
Total expenditure	427,653	477,829	513,430	560,198	607,151	662,111
Revenue expenditure	362,887	385,493	414,214	451,945	489,825	534,164
Capital expenditure	64,766	92,335	99,214	108,252	117,325	127,945
Revenue Deficit	99,860	76,171	90,676	91,466	85,804	79,963
Fiscal Deficit	132,103	137,407	172,496	182,994	187,041	191,820

the baseline scenario. The deficit projections under these baseline assumptions are: a revenue deficit of 1.66% of GDP in the terminal year, and a 3.98% gross fiscal deficit. Accomplishing the goals of the FRBM hence involves finding ways to eliminate this projected revenue deficit of 1.66% of GDP in 2008-09. In addition, the fiscal deficit needs to be brought below 3 per cent of GDP.

Table 3.6 also shows that from 2005-06 till 2008-09, the annual improvement in the revenue deficit fail to achieve the minimum requirement of 0.5 per cent per year. In addition, in 2005-06, the decline in the fiscal deficit is likely to be inferior when compared with the minimum requirement of 0.3 per cent per year. This issue is highlighted in Figure 3.3.

The strategy for fiscal consolidation, required in order to achieve the FRBM targets, will need to emerge with policy proposals which improve upon these baseline projections, and address these four deficiencies of the baseline scenario: (a) Achieving the requirement of no revenue deficit by 2008-09, (b) Achieving a fiscal deficit of below 3 per cent of GDP by 2008-09, (c) Improving the revenue deficit

Figure 3.2 Deficit projections under baseline scenario

The graph shows projections for the revenue deficit and the fiscal deficit under the baseline scenario. The FRBM Act requires the elimination of the revenue deficit by 2008-09, and the FRBM Rules require that the fiscal deficit should be below 3 per cent of GDP by 2008-09. Both these requirements are violated under baseline projections.

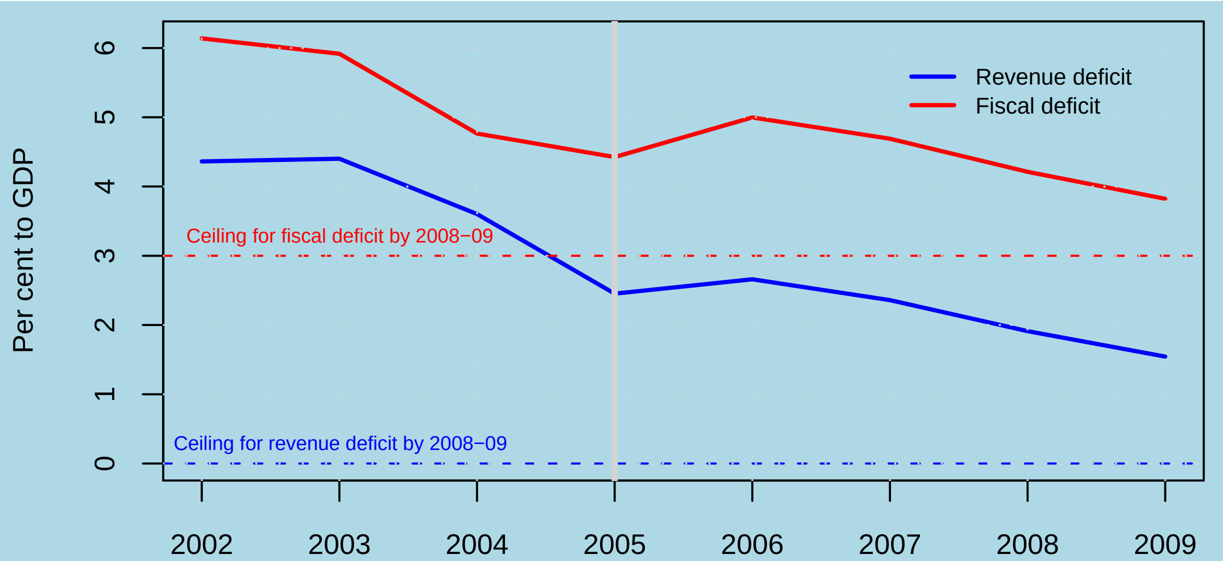


Figure 3.3 Improvements in deficits under baseline scenario

The FRBM Rules require that the revenue deficit should be reduced by 0.5 percentage points every year, and that the fiscal deficit should be reduced by 0.3 percentage points every year. The graph shows one-year changes in the two measures of the deficit under the baseline projections. Several of these projected one-year improvements fail to achieve the goals set by the FRBM Rules.

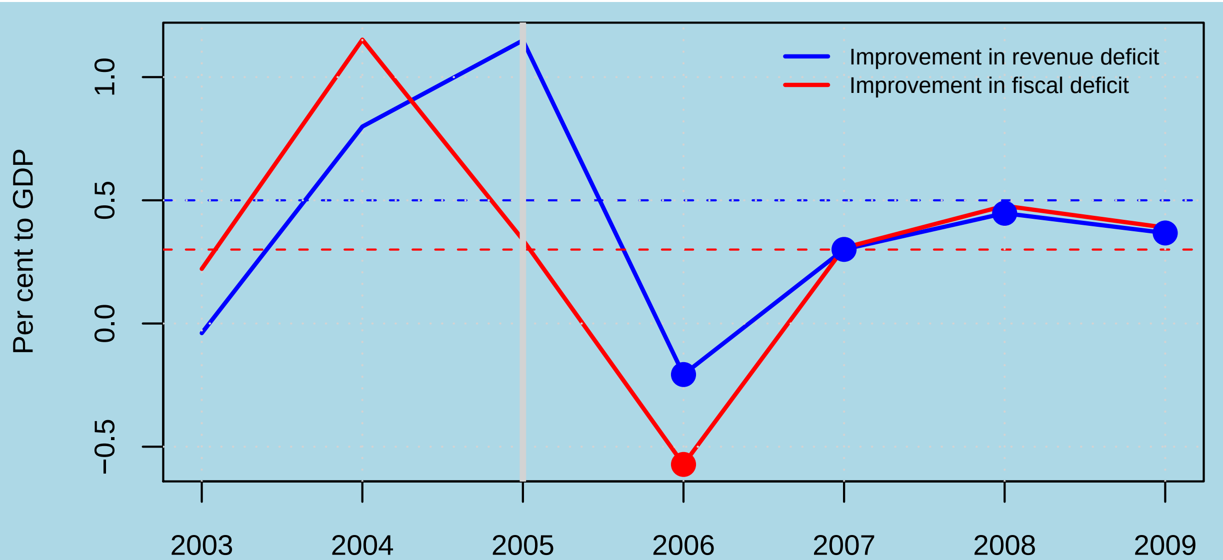


Table 3.6 Fiscal projections under baseline scenario (Per cent to GDP)

This table shows the full set of fiscal projections under the baseline scenario, expressed as per cent of GDP. This suggests that under prevailing trends, the revenue deficit will drop to 1.54 per cent of GDP in 2008-09, and the fiscal deficit will drop to 3.82 per cent of GDP.
The values in the table which are inconsistent with the FRBM Act or with the FRBM Rules are shown in *italics*. The goal of this report is to identify these inconsistencies and propose policy directions through which these inconsistencies can be addressed.

(Per cent to GDP)

	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09
Gross tax revenue	9.20	10.23	9.72	10.00	10.33	10.70
Revenue receipts	9.49	9.96	9.36	9.31	9.32	9.42
Tax revenue, net to centre	6.77	7.53	7.20	7.41	7.55	7.91
Non-tax revenue	2.72	2.43	2.16	1.91	1.53	1.51
Capital receipts	5.94	5.43	5.46	5.14	4.38	4.31
Recoveries of loans	0.65	0.87	0.39	0.33	0.28	0.25
Other receipts	0.52	0.13	0.12	0.10	0.09	0.08
Borrowings and other liab.	4.77	4.43	4.96	4.71	3.80	3.98
Total receipts	15.43	15.39	14.76	14.42	13.46	13.74
Non-plan expenditure	11.04	10.70	10.04	9.65	8.98	8.84
Interest, debt servicing	4.49	4.17	4.14	4.08	3.82	3.91
Defence	2.18	2.48	2.06	2.01	1.96	1.91
Subsidies	1.61	1.40	1.28	1.13	0.92	0.82
Grants, loans to States,UTs	0.57	0.63	0.61	0.58	0.55	0.52
Other non-plan exp.	2.19	2.02	1.95	1.85	1.76	1.67
Plan expenditure	4.38	4.69	4.72	4.77	4.47	4.89
Total expenditure	15.43	15.39	14.76	14.42	13.46	13.74
Revenue expenditure	13.09	12.42	11.91	11.63	11.20	11.02
Capital expenditure	2.34	2.97	2.85	2.79	2.26	2.65
Revenue Deficit	3.60	2.45	2.61	2.35	1.98	*1.66*
Change	0.80	-1.15	*0.16*	*-0.26*	*-0.37*	*-0.32*
Fiscal Deficit	4.77	4.43	4.96	4.71	4.32	*3.98*
Change	-1.15	-0.34	*0.53*	*-0.25*	-0.39	-0.34

by atleast 0.5 per cent every year and (d) Improving the fiscal deficit by atleast 0.3 per cent ever year.

A striking feature of the baseline scenario is that revenue receipts are expected to be lower in 2008-09 as compared with 2004-05, owing to poor growth in indirect taxes which (in turn) stems from the expected decline in customs duties and the poor buoyancy of excise collections which has been historically observed. Hence, the reduction in the revenue deficit that is observed in the baseline scenario flows from an even sharper reduction in revenue expenditures: 166 per cent of the overall fiscal correction falls upon a reduction in revenue expenditures to GDP.

Chapter 4

Macro perspective on fiscal consolidation

Chapter 3 has argued that in the 'baseline scenario', there is a need of a substantial fiscal correction in order to achieve compliance with the FRBM Act. This chapter brings macroeconomic perspectives to bear on the questions and major policy choices concerning the trajectory to the FRBM targets.

4.1 Policy alternatives

The broad goal of macroeconomic policy is to find the most effective trajectory through which the FRBM goals can be achieved. There are two main questions about the implementation of the fiscal correction which is required by the FRBM: (a) The question of an early or a late adjustment, and (b) The question of how adjustment should be shared between taxation and expenditure. In this chapter, we seek to bring economic principles to bear on these two key choices.

4.1.1 Early versus delayed adjustment

Figure 4.1 shows alternative paths for the revenue deficit. One thing is clear, that the revenue deficit has to go to zero at the end of 2008-09. There is room for flexibility when it comes to the intermediate years.

However, there are alternative trajectories which can achieve this. It is possible to have a 'front-loaded adjustment', which emphasises finishing the bulk of the required fiscal correction in the early one or two years. Alternatively, there can be a 'back-loaded adjustment', which emphasises achieving the bulk of the required fiscal correction in the late years.

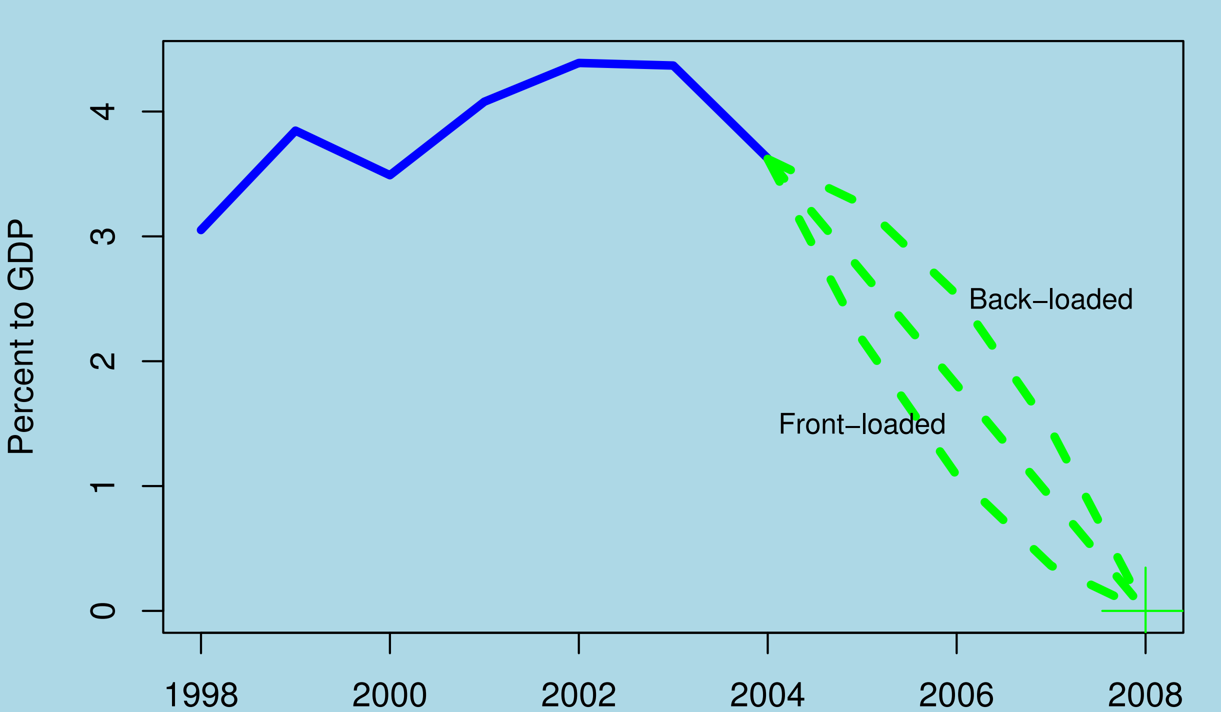
In addition, there is an important distinction between front-loaded *policy reforms* and front-loaded *fiscal adjustment*. It is possible to conceive of policy decisions taken early in the adjustment period, which generate a sustained impact over the following years.

4.1.2 Cutting expenditure versus raising tax revenues

The second key question about the fiscal correction concerns the relative role of revenue expenditure and revenue receipts. Going by the requirement of the FRBM, by 2008-09, the revenue deficit has to be eliminated. However, in terms of adjustment, many alternative paths can be envisaged. For example:

1. The existing ratio of revenue receipts to GDP could stay unchanged, and expenditure could adjust downwards, so as to be equal to revenue

Figure 4.1 Alternative paths to elimination of the revenue deficit



receipts as per cent of GDP by 2008-09.

2. Alternatively, the adjustment of 3.6 percentage points could be shared in half between the two.

3. Alternatively, revenue expenditure could stay fixed as per cent of GDP, and the tax GDP ratio could rise by 3.6 percentage points by 2008-09.

4. Alternatively, we could actually have a rise in revenue expenditure as per cent of GDP. For example, revenue expenditure could rise from the present level of 13.17% of GDP to a level of 14.17% of GDP. This would require a rise of 4.6% of GDP on the part of revenue receipts.

4.2 Business-cycle considerations

Reducing expenditure or raising taxes, in the quest for the FRBM targets, can be contractionary. At the same time, one of the goals of fiscal policy is to be countercyclical. There is a need to reconcile these two objectives. This requires a closer appraisal of questions about the business cycle, and the impact of taxation or expenditure proposals in terms of the business cycle.

4.2.1 Closed economy multipliers

In the standard Keyenesian framework of a closed economy, raising government expenditure G or cutting tax revenues T have a 'multiplier effect', with the following multipliers:

$$\frac{\Delta Y}{\Delta G} = \frac{1}{1 - \text{MPC}}$$
$$\frac{\Delta Y}{\Delta T} = \frac{-\text{MPC}}{1 - \text{MPC}}$$

Here, ΔY is the change in GDP associated with a change of ΔG in government expenditure or ΔT in taxes. The size of both multipliers is related to the marginal propensity to consume (MPC). These 'multiplier effects' are most useful as a guide for understanding situations where there is excess capacity in the country, and recessionary conditions prevail.

Since the savings rate in India is high, when compared with most OECD countries, we expect that the multipliers in India would be correspondingly smaller.

We see that the expenditure multiplier is larger; that the contractionary effect of cutting expenditure is larger than the contractionary effect of raising taxes. This is an argument in favour of placing a larger share of the required fiscal adjustment upon the growth of revenue receipts.

We may note that FRBM targets could also be met while increasing expenditure, where it would be required that the Tax/GDP ratio rise by more than 3.6%. In this scenario, *raising* expenditure would have an expansionary effect, which would partly counteract the contractionary effects of raising the Tax/GDP ratio.

4.2.2 Attenuation of fiscal multipliers in an open economy

It is important to emphasise that the above relationships are for a closed economy. In an open economy, characterised by a combination of trade flows, capital flows, and a flexible exchange rate, these multipliers are considerably weakened.

When there is a domestic fiscal contraction in an open economy, the weakness in domestic demand is counteracted by a depreciation of the currency, which improves net exports and aggregate demand. Given the increasing openness of the Indian economy, the fiscal multipliers may be smaller, and fiscal consolidation may have a lesser impact on aggregate demand.

4.2.3 Where are we in the business cycle?

The timing of fiscal consolidation has to be closely interwoven with the domestic and international business cycle. For example, if India had embarked on a strong fiscal correction in 2001-02, the welfare consequences would have been highly negative.

As of early 2004-05, we appear to be standing at a relatively high point in the domestic and international business cycle. Business confidence is high. Investment demand has grown well, with imports of capital goods having grown by 31% in the period from April 2003 to February 2004, compared with the previous year. There is heightened interest in India as a destination for FDI, and in integrating India into global production chains for manufacturing and services.

In 2002 and early 2003, there were global fears of slow economic growth and deflation. However, the international business cycle has turned around, with a distinct pickup in growth in the US and Japan. Commodity prices are sharply on the upswing in 2004.

This environment constitutes an argument in favour of front-loading. As John F. Kennedy argued, *the time to fix the roof is when the sun is shining*. At this moment, the welfare costs of the fiscal adjustment will be the most muted. Furthermore, if India is able to obtain substantial progress in the fiscal adjustment in 2004-05 and 2005-06, then this will ‘recharge the guns’ of fiscal policy for possible use in countercyclical fiscal policy, which may be required if the domestic and the world business cycle turns around in the future.

The US is an important case study in this regard (Figure 4.2). The US achieved a dramatic fiscal consolidation in the years after 1992, at a time when the US economy was growing strongly. This created the fiscal space for countercyclical fiscal policy, in the form of the enormous tax cuts which were implemented in recent years in order to counteract the downswing of the business cycle. If the fiscal consolidation had not taken place in the US over 1992-2000, then it would not have been possible to use fiscal policy as a tool for tackling the recession of the following years.

4.2.4 Investment-led growth

In the mid 1990s, India experienced a boom in investment until 1995. After this, investment demand has been weak, except for the spurt in investment which was also observed in 1999-2000.

This has been a period of consolidation, where firms were improving efficiency, and optimally utilising existing capacity. Largely speaking, after 1995, growth in consumption played a prominent role in obtaining GDP growth.

This period of better utilising existing capacity now seems to be behind us, and the next wave of GDP growth in India is likely to be based on investment. Some evidence of an upsurge in investment is visible in the early months of 2004 for which data is available.

From the viewpoint of macro policy, our goal should be to best harness this cyclical revival of investment, to prolong the period of positive expectations and high investment rates, and to maximise the impact that these investments have upon GDP growth.

The fiscal reforms process needs to foster this process of investment-led growth, by establishing a non-distortionary and effective tax system to raise revenues, and by pursuing expenditure policies which yield an adequate quantity and quality of public goods.

4.3 Other considerations

4.3.1 Lags in policy

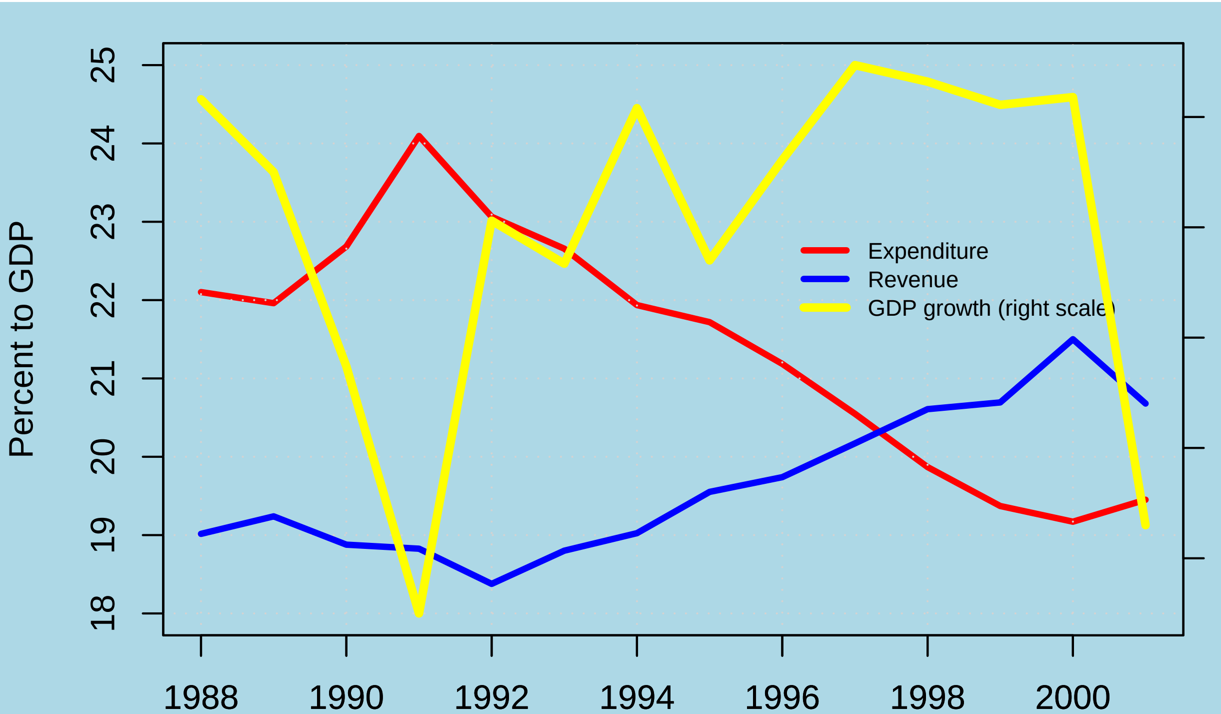
Fiscal consolidation is about reforms in revenues and reforms in expenditure. There is an innate time delay between decisions and their full impact upon the revenue deficit.

We may outline the sequence of events that might unfold. First, a new policy would be *adopted*. After this, there would be a time delay required for *implementation* in terms of processes and IT systems. There would then be a time delay for these systems to *stabilise*.

Finally, there are time delays before the full impact of new policies is seen in terms of *behavioural impact*. A central plank of tax reforms consists of finding strategies which give firms and households *incentives* to behave in a different way, and in a way that is compatible with a reduction in the revenue deficit. This would require some time to fall into place, as firms and households gradually shift away from traditional decision processes, which are rooted in a distortionary

Figure 4.2 Fiscal adjustment in the US in the 1990s

There are numerous international precedents of comparable adjustments taking place in a short time. One prominent example of a substantial fiscal adjustment was that of the United States in the 1990s, which is shown in the chart. A striking fact about this period was the acceleration of GDP growth that took place along with this fiscal consolidation. This phenomenon of 'expansionary fiscal consolidation' has also been experienced by many other countries which have embarked on fiscal consolidation.



fiscal system, and shift into new ways of thinking.

Through these channels, there will innately be some lag between policy *decisions* and their full impact on the revenue deficit. This constitutes an argument in favour of front-loading of *decisions*. At the same time, this suggests that while decisions should be front-loaded, their full impact should only be expected with a lag. The full impact of a decision on reforms in 2004-05 will only be seen in 2005-06, 2006-07 and beyond.

4.3.2 Flexibility on capital expenditure

It is important to emphasise that the focus of the FRBM is on ensuring that *revenue* receipts exceed *revenue* expenditure. FRBM does leave government with flexibility in engaging in capital expenditure.[1]

[1] Increased capital expenditures do impinge upon the calculations required by the FRBM, if they are financed by bond issuance. For example, if capital expenditure takes place in 2004-05 using bond issuance, then the interest payments on these bonds would serve to increase revenue expenditures from 2004-05 onwards, and would require a consequential increase in revenue receipts in order to ensure that the revenue deficit is eliminated by 2008-09.

Hence, if there are strong fears of the contractionary effects of increasing tax revenues, or cutting expenditures, then increasing capital expenditures remains available as a policy tool.

From a debt dynamics perspective, capital expenditures can be safely undertaken when future user charges and the incremental tax revenues from the increased future GDP (caused by the new capital goods) are large enough. In technical terms, government can confidently build a railway line costing Rs.1000 crore, financed by issuing a bond worth Rs.1000 crore, when the NPV of the increased tax revenues on the increased GDP in the future, coupled with the NPV of future user charges, exceeds Rs.1000 crore.

If this condition is not met, then capital expenditures which are financed by issuing bonds serve to raise the Debt/GDP ratio and are not fiscally sustainable. This difficulty poses significant constraints upon the ability of government to easily ramp up countercyclical capital expenses in a way that does not adversely affect debt dynamics.

This approach emphasises the need to acute care in the *institutional design* of the processes through which debt-financed capital expenditures are undertaken. This aspect also links up to the issue of lags in policy discussed in Section 4.3.1, since creating new institutional mechanisms to achieve high quality capital expenditure (in the sense sketched above) is difficult and time-consuming.

Table 4.1 summarises the experience with one successful experience of capital expenditure by the Centre: that of NHAI. The Union Budget for 1998-99 had provided for the fuel cess, and 1998-99 can be viewed as the first year of the highway-building effort. As the table shows, it was only in year 4 that the capital expenditure reached a level of roughly 0.2% of GDP, and in year 6 that it reached 0.33% of GDP.

Table 4.1 Buildup of capital expenditure of NHAI

	Year	Capital expenditure (Rs. crore)	Capital expenditure (Percent to GDP)
2	1999-00	746	0.04
3	2000-01	1,261	0.06
4	2001-02	3,997	0.18
5	2002-03	6,584	0.21
6	2003-04	9,525	0.33

This suggests that if there is an intent of engaging in countercyclical capital expenditures in the period 2007-2009, institutional mechanisms through which these will take place need to be created well ahead of time.

4.3.3 Expansionary effects of tax reforms

The above discussion has focused on the contractionary effects of the fiscal consolidation, and how this can be directly counteracted.

At the same time, there are many important channels through which fiscal consolidation is expansionary. In many countries, there have been experiences of 'expansionary fiscal consolidation', which underline the importance of these channels of influence.

In India's case, the most important positive impact is rooted in tax reforms themselves. Tax rationalisation, removal of exemptions, and modernisation of tax administration will innately reduce deadweight costs, reduce the extent to which resource allocation is distorted in the quest for tax evasion, and thus raise productivity. These improvements can be viewed as positive productivity gains which will be caused by tax reforms. They will fuel GDP growth in the years that follow the tax reforms.

The second channel lies through interest rates and the bond market. To the extent that the fiscal deficit goes down, Government would make a smaller claim on resources through bond issuance. This would reduce the crowding out of the private sector, make greater resources available to the private sector, foster reduced interest rates and a lower cost of capital for equity and debt, and foster economic growth.

Tax reforms would give greater support to entrepreneurship, support relatively labour-intensive small and medium enterprises, and reduce the cost of capital for risk capital. Through these channels, resource allocation would be improved.

Credit rating agencies have focused on India's fiscal problems as the defining issue which has led to near-junk ratings for Indian debt.[2] When India is visibly seen as making progress on the fiscal question, India's credit rating would improve. This would reduce the cost of capital faced by firms when borrowing abroad, and thus further spur investment.

Domestic capital markets and business confidence would improve, when it is seen that Government is serious about establishing prudent ground rules.

Thus, there is a strong link between fiscal consolidation and an expansion of investment and thus employment in the economy. Conversely a failure to make progress on fiscal consolidation would lead to a continued preemption of investible resources, and lower job creation.

4.3.4 Positive impact on state finances

In the last decade, the finances of state governments have been facing extreme stress. This has manifested itself in poor production of local public goods, most of which are controlled at the state level. Weaknesses in health, education, water and sewage, local roads, etc. are all important problems which hold back GDP growth. There is an urgent need to improve expenditures on health and education.

At present, many state governments have signed *Memoranda of Understanding* which require elimination of the revenue deficit by 2005-06. The accomplishment of this target is a central issue that is shaping policies at the state level.

This constitutes a strong argument in favour of front loading. If the centre is able to improve the Tax/GDP ratio in 2004-05 and 2005-06, then roughly 30% of these increased proceeds will go to the state governments, where they will substantially alleviate the state fiscal crisis, help achieve the targets agreed to under *Memoranda of Understanding*, lead to improved production of local public goods and thus strengthen the development process at the grass-root level.

This constitutes one of the most important channels through which expenditures on health and education, which are state subjects, can be sharply increased in the near future.

[2] Using ratings by S&P, the median values for the central interest / revenues ratio for various rating categories were as follows: BBB (8.68%), BB (19.21%), B (16.68%). The median values for the central government Debt/GDP ratio for various rating categories were as follows: BBB (29.98%), BB (55.95%), B (70.8%). By S&P scales, investment grade runs from AAA till BBB-. Below that, starting from BB+, is speculative grade.

4.3.5 Need for pre-announced trajectory

Government is presently engaged in medium term fiscal planning, leading to a removal of the revenue deficit by 2008-09. These plans necessarily involve many actors, will be phased in over a period of years, and will have a considerable impact upon the optimising decisions of individuals and firms.

These decisions of economic actors will be best undertaken under conditions of fuller information, and sound expectations about the future. The changes in policy will undoubtedly affect the economy, but they will have the smallest effect if economic agents have sound expectations about the future, and are able to well anticipate the changes that are underway.

This suggests a need for good quality disclosure by government about the path to 2008-09, to ensure that there is full transparency about the path, and to minimise the shocks to the economy that come about from policy announcements.

4.4 Proposals

To summarise, there are a number of arguments favouring fiscal consolidation through higher tax revenues rather than reduction in expenditure:

- Raising tax revenues helps state finances through the devolution of resources, and thus fuels GDP growth through better resource flows into local public goods. In contrast, cutting central expenditure does not address the problem of local public goods.
- The expenditure multiplier is larger than the tax multiplier, hence the business cycle implications of cutting expenditures are more onerous than the business cycle implications of raising tax revenues.
- Tax reforms, which move towards a *simple* tax system, yield positive productivity gains: they eliminate deadweight costs and reduce distortions in resource allocation. Through this, they serve to boost GDP growth and employment growth.

There are several reasons that indicate the desirability of front-loaded fiscal consolidation compared with back-loaded fiscal consolidation:

- Swift and decisive actions would greatly strengthen the credibility of the country's economic policy making.
- The domestic economy and the world economy are faring well in terms of business cycle issues. Fears of deflation have receded, and there appears to be little slack capacity. Hence, a front-loaded fiscal consolidation may not adversely affect demand.
- An early fiscal consolidation will 'reload the guns' for countercyclical fiscal policy two moves ahead.
- An early fiscal consolidation will quickly free up resources for investment by the private sector. It will quickly improve India's credit rating, improve investment flows, and accelerate GDP growth.
- An early improvement in the central Tax/GDP ratio will swiftly ease the difficulties of state finances, and thus have a positive impact on the development process at the state level.
- Owing to lags in policy, decisions taken in 2005 will fully yield fruits in terms of higher GDP growth and sound fiscal outcomes by 2006 and 2007. It is hence important to take *decisions* early about reforms in tax and expenditure policies, so as to benefit from the full impact of these decisions by 2008-09. The ideal sequencing is thus one where a comprehensive exercise in reforming tax policy is put in force early. The full impact of this upon fiscal *outcomes* would come over a two to three year period, reflecting the time taken to build sound

tax administration, for behavioural changes to take place among firms and households who would then shift out of their existing distorted states, and for higher GDP growth rates to materialise.

- FRBM also places obligations on the Debt/GDP ratio. A slow fiscal consolidation will give a greater accumulation of debt.

In the light of this analysis, the four fundamental principles for an Indian strategy in achieving fiscal consolidation may be articulated as follows:

I. Fiscal consolidation should be revenue-led.

II. Fiscal consolidation should be front-loaded.

III. Capital expenditure should be enhanced, while simultaneously engaging in institutional reform to ensure an adequate translation of capital expenditure into an increased flow of GDP.

IV. The reforms efforts on revenue expenditure should be further intensified.

Chapter 5

Policy proposals

5.1 ATTAINING A FISCAL CORRECTION OF 1.66% OF GDP BY 2008-09

The[1] baseline projections, show that assuming present trends in policies and implementation continue, the revenue deficit is expected to reduce to 1.66% of GDP by 2008-09. If the coming years are similar to the past few years, in terms of progress on tax policy and administration, the FRBM goals will not be met. New policies and new efforts in implementation will be needed to achieve the remaining task.

The baseline projections imply that in 2008-09, GDP would be Rs.48,20,389 crore. Hence, each percentage point of GDP would correspond to Rs.48,204 crore. The required fiscal adjustment, of 1.66% of GDP, corresponds to Rs.79,963 crore.

It is possible to envisage a correction of 1.66% of GDP that is done entirely on the expenditure side. This would require identifying programs to be discontinued, and administrative interventions through which expenditure could come down by 1.66% of GDP. On the other hand, if the fiscal correction is entirely revenue driven, the required additional resource mobilisation through taxes would need to be larger, given the devolution of resources to the States. The size of the increased gross tax revenues required will therefore vary with the expenditure-revenue mix of policy alternatives.

This required adjustment, of 1.66% of GDP in four years, appears large when compared with India's own experience, where the Tax-GDP ratio has generally not changed by more than 1.5 percentage points in any four year period. However, the international experience in this regard is revealing. Table 5.1 shows some four-year episodes where the Tax-GDP ratio rose by more than 4 percentage points, among the largest countries (defined as a PPP GDP which is larger than $200 billion).

This table shows 53 examples of such episodes, of countries where an increase in the Tax-GDP ratio of this size was attained over a four–year period. This ranges from Argentina's four-year period, ending in 1979, where the Tax/GDP ratio rose by 15.53 percentage points, to Brazil's experience in the four-year period ended 1993, where the Tax/GDP ratio rose by 4.01 percentage

[1] This chapter draws heavily upon the work of Dr. R. J. Chelliah, Dr. Amaresh Bagchi, Dr. Parthasarthi Shome, Dr. M. Govinda Rao and numerous government committee reports.

Table 5.1 Some four-year episodes of large increases in the Tax-GDP ratio

Country	Year ended	Change in Tax/GDP	Country	Year ended	Change in Tax/GDP
Argentina	1979	15.53	Italy	1982	4.93
Argentina	1978	14.11	Belgium	1977	4.89
Argentina	1980	10.42	Australia	1977	4.89
Argentina	1981	9.37	Spain	1989	4.88
Iran	1999	7.69	Spain	1988	4.83
Turkey	1999	7.30	Argentina	1993	4.82
Iran	1997	7.28	Malaysia	1980	4.75
Turkey	2000	6.90	Argentina	1985	4.74
Egypt	1980	6.79	Turkey	2001	4.72
Italy	1983	6.44	Spain	1987	4.67
Japan	1991	6.29	Spain	1986	4.60
Sweden	1977	6.24	Belgium	1975	4.60
Egypt	1994	5.89	Belgium	1976	4.60
Turkey	1997	5.71	Sweden	1990	4.51
Sweden	1997	5.63	Japan	1992	4.47
Sweden	1998	5.59	Japan	1993	4.45
Sweden	1978	5.54	UK	1983	4.33
Argentina	1986	5.54	Switzerland	1976	4.32
Malaysia	1977	5.48	South Africa	1985	4.29
Iran	1978	5.39	Italy	1993	4.26
Iran	1998	5.30	Sweden	1987	4.24
Belgium	1978	5.24	Argentina	1994	4.23
Italy	1986	5.18	Italy	1984	4.21
Indonesia	1976	5.16	Philippines	1992	4.13
UK	1982	5.13	Egypt	1993	4.09
Turkey	1998	5.01	Thailand	1991	4.01
			Brazil	1993	4.01

points.[2]

An interesting feature of this table is that a diverse range of countries are present. There are poor countries and rich countries; there are a few dictatorships and many democracies; there are countries from all continents.

This suggests that the fresh efforts now required in India are not unusual by world standards. The goals that we face have been achieved by many other large countries, often under conditions of inferior access to modern information technology for improving the tax administration.

5.2 Strategy for tax reform

In previous chapters, we argued in favour of a revenue driven strategy for achieving the FRBM targets. Given the limited scope of raising non-tax revenue, meeting the FRBM target of elimination of revenue

[2]Sometimes, countries appear in this table multiple times. This implies a sustained large rise in the tax-GDP ratio over a period longer than four years. For example, the first four lines in the table are all about Argentina. This means that in the four-year period ended 1979, the tax-GDP ratio grew by 15.53 percentage points, *and* that in the four-year period ended 1978, the tax-GDP ratio grew by 14.11 percentage points, etc.

deficit implies increasing the tax-GDP ratio. Such an increase has an important associated benefit due to its positive impact on the State finances.

An enhanced tax-GDP ratio should be achieved through policies which are compatible with the core economic policy goals of promoting efficiency, equity and high quality growth. This implies that additional resources should be obtained through a non-distortionary tax regime supportive of saving and entrepreneurship. The tax system should not induce households and firms to distort their behaviour in inefficient directions owing to tax compulsions.

We may sketch the elements of a reform strategy which would achieve these goals as follows.

1. *Widening the tax base*. In preceding decades, India has experienced the difficulties associated with high rates and pervasive tax avoidance efforts by firms and households.

   Expanding the tax base, rather than increasing rates, is hence the preferred strategy.

   One element of broadening the base comprises addressing the problem of exemptions. For many decades, the tax base has been whittled away through a steadily escalating range of exemptions. The removal of these exemptions will have twin implications. First, it would lead to a higher tax-GDP ratio. Second, it would enhance GDP growth, since tax exemptions and deductions distort allocative efficiency, undermine equity (both horizontal and vertical), increase compliance costs, impose administrative burdens, and encourage corruption.

   The second element of broadening the base comprises broadening the scope of the tax system to bring within its fold economic activities which were hitherto exempt.

2. *Low rates; few rates*. High tax rates distort economic decisions and fuel the deployment of resources into tax avoidance and tax evasion. A large number of rates of taxes exacerbates the problem of bracket creep and classification disputes. These arguments suggest that a rational tax system is one with very few rates and low rates. For example, debates on customs duties have universally argued that if customs tariffs have to exist, there should be a single uniform rate on all goods. Similarly, it is well accepted that there should be a single VAT rate covering all kinds of production.

3. *Enhancing equity of the tax system*. Reform of the tax system should further both vertical and horizontal equity.

4. *Shift to non-distortionary consumption taxes to increase efficiency in production and enhance international competitiveness of Indian goods and services.*

   High import tariffs, excises and turnover tax on domestic goods and services have enormous cascading effects, leading to a distorted structure of production, consumption and exports. This problem can be effectively addressed by shifting the tax burden from production and trade to final consumption, and from savings to consumption.

   A well designed destination-based VAT on all goods and services is the most elegant method of eliminating distortions and taxing consumption. Under this structure, all different stages of production and distribution can be interpreted as a mere tax pass-through, and the tax essentially ‘sticks’ on final consumption within the taxing jurisdiction.

   The existing tax system introduces myriad distortions which favour some goods and services at the expense of others. These distortions yield inefficient resource allocation, and come at the price of inferior GDP growth. The existence of such *potentialities* in the framework of tax policy generate rent-seeking behaviour on the part of firms, who have incentives to engage in political lobbying seeking favourable modifications in the tax schedule.

   The Indian consumer is known to be remarkably sensitive to apparently small changes in relative prices. The goal of a rational tax system is to *empower households* to engage in undistorted decision making, driven by their own needs and preferences, and not decisions made in the Ministry of Finance.

5. *Enhancing the neutrality between present consumption and future consumption.* At present, the tax system is neutral between consumption and savings. Consumers typically favour present consumption over future consumption. Hence, neutrality between consumption and savings tends to depress savings rates and investment. Tax reform should impart intertemporal neutrality in consumption.

6. *Enhancing neutrality of the tax system to the form of organisation*. Teams or groups of individuals can be organised in many different organisational structures, such as limited liability companies, associations, clubs, partnerships, limited liability partnerships, etc. Each of these forms of organisations has its own strengths and weaknesses in raising capital, handling conflicts of interest, enabling decision making, etc. The choice of organisational structure adopted by decision makers in the economy should be driven by efficiency considerations and not tax considerations.

7. *Enhancing the neutrality of the tax system to sources of finance*. The choice between debt and equity and between retention and distribution of profits should not be distorted by tax considerations.

8. *Establishing an effective and efficient compliance system*.Good tax policy cannot exist without good tax administration.Whenever actual practice differs from legislative intent, policy decisions are being made by tax administrators. Compliance costs upon taxpayers are a major problem faced in the economy. The mission of the tax administration to collect revenues for the Government through a legally defined tax system, in an effective, equitable and efficient manner. Achieving these goals involves four elements:

   - Establishing a program for taxpayer service and education to promote voluntary compliance with tax obligations;
   - Making non-compliance risky for violators;
   - Simplifying compliance procedures to reduce transaction costs;
   - Using information technology comprising of state-of-the-art computer technology as well as comprehensive and integrated systems covering all functional areas of the tax circuit, capable of providing accurate, timely and sufficient information. This will enhance transparency and integrity, thereby inspiring public confidence in the tax administration.

9. *Focus on buoyancy rather than immediate sources of tax revenue*.

   Tax revenues can always be increased by imposing ad-hoc taxes. For example, it is always possible to pick one sector with easy enforceability - such as telecom - and impose a tax on it. However, such an approach is not a long-term foundation for a sound tax system. Such ad-hoc taxes have been seen to induce deeper distortions in the economy, adversely affect the growth of GDP through misallocation of resources, and set the stage for new kinds of tax avoidance mechanisms.

   The reforms strategy of this report focuses on establishing an economically efficient, effective and equitable tax system which will facilitate voluntary compliance. The focus is on raising tax revenues through increased tax buoyancy rather then ad hoc distortionary taxes.

Given this broad framework for tax reforms, we outline the proposals for reform of the services sector, customs, central excise, personal income tax and corporate taxes.

A recurring issue of central importance, in thinking about tax policy in India, is the subsidies implicit in tax exemptions. ‘Tax expenditures’ are revenue losses attributable to provisions of the tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability. These are also referred to as spending programs embedded in the tax law. The concept of tax expenditure rest on the assumption that tax rate should be applied to a comprehensive base so as to maximize tax revenue at any given tax rate. Tax provisions which shield taxpayer income comprehensively defined, from the liability of income tax are regarded as analogous to government expenditures. Since, all government expenditures are required to be voted by the Parliament, it is necessary and appropriate to enumerate, as part of the budget exercise, all tax expenditures and obtain specific approval of the Parliament.

A large number of countries across the globe have adopted this practice of presenting to their Parliament the various items of tax expenditure as part of their budget process. This has considerably enhanced transparency in designing tax policy. In fact, this has helped governments to ward off pressure from interested groups for various kinds of distortionary exemptions and exclusions.

The practice of reporting tax expenditures to the Parliament must be adopted as part of the budget process. It will enable the Parliament to scrutinize these expenditures with reference to their costs and benefits. Therefore, it will impart transparency and accountability in designing tax policies. However, a large number of issues particularly relating to measurement and identification of the tax expenditures would need to be resolved. Accordingly, we recommend the creation of a Task Force with the objective of identifying the various tax expenditures, the method of measurement, and the form of reporting.

5.3 The goods and services tax (GST)

5.3.1 Evolution and problems of union excise duties

Entry 84 in the Union List in the Constitution of India empowers the Central Government to levy duties of excise on tobacco and other goods manufactured or produced in India,[3] thereby excluding services by implication. Therefore, the central government is empowered to levy a tax on production of goods and not on consumption of goods. Accordingly, the Union excise duty is a tax applicable only on the manufacture of goods within the country. The value addition in the post manufacturing stage, being in the nature of services, is excluded from the tax base. The levy of union excise duties is governed by the Central Excise Act, 1944, and the Central Excise Tariff Act, 1985.

The term ‘manufacture’ has been interpreted to mean bringing into existence a new article having a distinct name, character, use and marketability. In some cases, even though the process may not give rise to a new article, the excise law deems such processes as manufacture. Examples of this include repackaging of specified bulk imports into smaller marketable lots, labeling, etc.

Over the years, the central excise duty structure has been fine-tuned for various objectives including social considerations and purely revenue considerations. It is replete with exemptions and incentives.

[3] This is subject to the following exceptions: (a) alcoholic liquors for human consumption. (b) opium, Indian hemp and other narcotic drugs and narcotics, other then medicinal and toilet preparations containing alcohol or any substance included in (b) above.

Excise duty reform began in 1986. but its progress has been relatively slow. The tax structure has improved considerably since the beginning of the 1990s; over a hundred excise rates in 1980s have been reduced to three main rates (Table 3). Unlike in the early 1980s when excise duty was levied at specific rates, it is now mostly levied on ad-valorem basis (i.e., on the basis of value). Where goods are liable to excise duty with reference to their value, the value is determined in the following manner:

Transaction value Transaction value is the price at which the goods are sold by an assessee at the time and place of removal where price is the sole consideration of sale and the seller and consumer are not related.

Maximum retail price Certain notified goods which are statutorily required to declare on the package thereof, a retail sale price, are charged excise duty on such retail sale price as reduced by applicable abatement. Goods such as beverages, refrigerators, lubricating oils, etc. fall under this category.

Some of the benefits from shifting to fewer rates have been neutralised by the 'tariff schedule' of abatement rates.

Basic excise duty (i.e. CENVAT) is now levied at a uniform rate of 16 per cent. This rate is applicable to about 85 percent of products, contributing 60 percent of the total excise duty revenues. However, a concessional duty rate[4] of 8 per cent is levied on some 34 products, like food products, matches (mechanised sector), cotton yarn, computers etc. Further, a Special Excise Duty (SED) at the rate of 8 per cent is also imposed on certain items like polyester filament yarn, cars, air conditioners, aerated waters and tyres. An additional excise duty (AED) is levied on goods of special importance like sugar, tobacco, textiles, or to collect the road cess. A National Calamity Contingency Duty ('NCCD') has been introduced on specified tobacco and tobacco products from 1 March 2001. There are also a number of commodities, which attract excise duty at specific rates, which are based on quantity or weight. Some of these commodities are edible oils/vanaspati, sugar, cement, and molasses.

The concept of allowing credit for tax paid on intermediate goods - a move towards the VAT principle - was also introduced. The excise law now provides for a Central Value Added Tax (CENVAT) Credit Scheme, which limits the cascading effect of duty incidence on a number of excisable goods that are used as inputs / capital goods for use in manufacture of other excisable goods. Under the scheme, CENVAT credit can be claimed on the excise duty, special excise duty, NCCD and additional duty of customs imposed on raw materials and capital goods, whether purchased locally or imported. This credit can be utilised for payment of excise duty on the finished products.

Nevertheless, despite the apparent progress with the VAT mechanism, distortions remain within the overall structure that adversely affect resource allocation and efficiency of administration. This is because of several factors.

For example, after having introduced and implemented immediate VAT-credit on capital goods for four years, in 2000, the credit was scaled back to be given over two years. This was apparently done for recouping revenue, but these kinds of modifications affect business planning and lead to administrative discretion and disputes. Further, while a main

[4]This is done by way of a partial exemption notification.

Table 5.2 Excise rationalisation: 1990-2004

Year	No. of basic duty rates *ad valorem*	Peak basic rate *ad valorem*
1990-91	19	110%
1991-92	19	110%
1992-93	19	110%
1993-94	19	110%
1994-95	17	110%
1995-96	12	50%
1996-97	9	40%
1997-98	10	40%
1998-99	11	40%
1999-00	3 basic rates + 3 SED rates	24% Basic + 16% SED
2000-01	Single rate 16% CENVAT + 3 SED rates	16% CENVAT + 24% SED
2001-02	Single rate 16% CENVAT + 1 SED rates	16% CENVAT + 16% SED
2002-03	Single rate 16% CENVAT + 1 SED rates	16% CENVAT + 16% SED
2003-04	Single rate 16% CENVAT + 1 SED rates	16% CENVAT + 8% SED

rate of 16 per cent has been announced and it is claimed that over 85 per cent of the goods are taxed at the main rate, there are other rates at which the remaining goods are taxed. The lack of clarity in classification, for which peripheral rates apply, creates administrative hurdles.

Though the rate structure has improved considerably since the beginning of the 1990s, the leakages in the tax base have not been plugged. A major problem is the continuance of exemptions from CENVAT. In any standard publication about central excises, about 1/3 of the total pages are devoted to exemptions alone. Though the exemptions are divided into about 70 broad categories, they are sub-divided under 259 entries, 52 conditions and 7 lists, with numerous items under each list. Some of the exemptions, which significantly erode the tax base, relate to the small-scale industry sector and area based exemptions.

Exemptions hamper transparent administration, particularly when such exemptions are made subject to qualitative conditions as is the case in India, such as the consideration if the exemption under question should be interpreted strictly or liberally. In effect, that decision is left to junior officers such as the appraisers, superintendents and assistant commissioners. These problems have rendered a simple tax such as the VAT relatively complex to administer, under which corrupt officials and tax evaders could thrive comfortably.

Thus, while there has been palpable progress in restructuring the central excise rate structure as well as in reducing distortions by minimizing taxation of inputs, existing leakages from the tax base through exemptions continue to pose a major problem. Cleaning up exemptions would clearly raise revenue-productivity and improve the quality of tax administration.

Most developing countries that have seriously undertaken reform of domestic consumption taxes at the central government level such as Argentina, Bangladesh, Peru, Chile, Colombia, Indonesia, Korea, Nepal, South Africa, and Thailand to name a few, have endeavored to introduce a simple VAT with a broad base and a few rates, and a simple law with little confusion or complexity in interpretation. And most have achieved their goals relatively successfully.

India is yet to fully catch up with such reforming countries in its VAT reform at the central level. Indirect tax policy in India tends to be constantly battered by special interest groups that find it to their interest to have the structure cater to their particular benefit. This is where a single rate VAT has the strongest appeal, by being immune to special interest lobbying.

5.3.2 Evolution of taxation of services

In India, as in any other growing economy, the share of the services sector in the GDP has increased over time. The exclusion of the service sector from the tax base restricted the revenue productivity of the tax system. Therefore, the focus shifted to increasing tax rates, particularly rates of union excise duties, to maintain the Tax/GDP ratio and the fiscal balance.

The demand for services is income elastic since richer sections of the community consume a disproportionately higher proportion of their incomes on services as compared with the poor. Therefore, extending the tax to the services sector is desirable also from the viewpoint of both horizontal and vertical equity.

Further, the burden of taxation was being borne mainly by the consumers of goods and not consumers of services. This favorable tax treatment caused resources to be allocated in favor of the latter. The lopsided distribution of tax burden on goods tended to affect consumers' choice in favor of consumption of services as opposed to goods.

Recognizing the case for taxation of services on grounds of efficiency, equity and revenue productivity, the Tax Reforms Committee (1991) recommended the levy of a tax on services, to begin with, on a selective basis. However, the central government did not have the explicit powers under the Union List to levy tax on services. Further, the power to levy tax on services was also not covered either under 'State List' or 'Concurrent List'. Therefore, in exercise of its residuary power under entry 97 of the Union List of the Seventh Schedule to the Constitution of India, the Central Government introduced, for the first time, by the Finance Act, 1994, a 5 per cent levy on only three services. There was no provision for input credit of any kind. At present the service tax is levied on 58 services at the uniform rate of 8 per cent with a provision for input credit across services.[5]

Since the introduction of tax on services, in 1994, the design of the tax on services has been the subject matter of consideration by a number of committees / task force setup by the Government of India from time to time. These committees have unanimously recognised that selective taxation of services covering a small proportion of the activity in the service sector, is distortionary and adversely affects neutrality both between services and goods and services. It also causes definitional ambiguities giving rise to classification disputes. When some services are taxed and some are not, there will always an attempt on the part of the service provider to label their service as belonging to the non-taxable category. Therefore, all committees/task forces have

[5]The Finance Bill 2004 introduced in the Lok Sabha on 8th July, 2004 proposes to extend this levy to 13 new services at a uniform rate of 10 per cent and a provision for input credit across goods and services.

recommended the taxation of all services, in order to achieve neutrality in taxation. Exclusion, if any, should be only on grounds of significant externalities, merit good elements, distributional considerations and administrative feasibilities.

5.3.3 Integration of union excise duties and service tax

Even if the service tax and Union Excise duties were each independently comprehensive, this would not be an adequate answer. Independent taxation of goods and services under different legislations creates the same kind of problems as selective taxation of services. The line between goods and services is getting blurred by the day, giving rise to immense disputes incapable of being resolved either through circulars or courts. All disputes must necessarily end in the Supreme Court. In fact, even after a decision by the Supreme Court, it is immensely difficult to give effect to the principles enunciated by the highest court.

The problem is further aggravated with the advent of digital technology. Goods and services have become indistinguishable and can be subjected simultaneously to a tax that is applicable only to goods and at the same time under a law that is intended to primarily tax services.[6] Further, there is a strong interdependence of goods and services in the production and distribution activities in the economy. A large number of services taxed by the central government independently of the CENVAT are used in the business of manufacturing goods and do not go directly to consumers. Similarly, a large number of goods liable to CENVAT are used in rendering the services liable to service tax. Stand alone taxation of both goods and services is structurally inconsistent with the scheme of input credit across goods and services which is so vital to eliminating multiple taxation and cascading effects. Further, both administrative and compliance cost considerations necessitate integration.

Therefore, *the tax on services should be fully integrated with the existing Central VAT (CENVAT) on goods by a modern VAT-type levy on all goods and services to be imposed by the central government* (hereafter referred to as "Central-GST"). The design of the Central-GST should have the following features:

1. Since the Central Government is now empowered to levy tax on all services, the value addition in the post manufacturing stage, being in the nature of services, can also be taxed by the central government. Accordingly, the practice of allowing abatement on the maximum retail price in the case of goods/commodities subject to Standards and Weights Measurement Act, should be discontinued.

   Further, in the case of all other goods, (including petroleum products and tobacco), the base for the levy under the new legislation should not be restricted to the price at the time and place of removal of the goods but should extend to the retail price. It would not be necessary to distinguish between goods and services, thus eliminating classification disputes. Therefore, the tax base must comprehensively extend over all goods and services going up to the final consumer, reflecting the tax base of a typical consumption VAT.

2. The computation of the Central-GST liability should be based on the invoice credit method i.e., allow credit for tax paid on all intermediate goods or services on the basis of invoices issued

[6] See Escotel Mobile Communications vs. Union of India(Kerala). The matter is now pending before the Supreme Court.

by the supplier. This will facilitate elimination of the cascading effect of a separate commodity and service tax at various stages of production and distribution, arising due to the existing system of restricting the input credit within the service sector to the service inputs.

3. It should be structured on the destination principle. As a result, the tax base will shift from production to consumption whereby imports will be liable to tax and exports will be relieved of the burden of goods and services tax.

4. The number of tax rates should be restricted to three *ad valorem* rates in addition to the zero rate. These three rates should be a standard rate of 12 per cent for most commodities and services, a lower rate of 6 per cent on necessities like processed foods and matches and a higher rate of 20 per cent on items like automobiles, air-conditioners, aerated water and polyester fibre yarn. The limited number of rates will eliminate classification disputes.

5. There should be no specific tax rates except for petroleum and tobacco products. Accordingly, specific rates should be converted to *ad valorem* rates which should be set at 6 per cent for sugar, edible oils, and vansapati and 12 per cent for cement.

6. All exports should be zero rated.

7. Exclusion from the tax base, if any, should be only on grounds of significant externalities, merit good elements, distributional considerations and administrative feasibilities. Therefore, the new legislation must provide for a well defined negative list of goods and services for exclusion from the tax net. This list may comprise of the following:

   (a) Commodities with negative externalities whose consumption needs to be checked;

   (b) All public services of Government (Central, State and municipal/ panchayati raj) including Civil administration, defense para-military, police, intelligence and Govt. Departments but excluding Railways, Post & Telegraph other commercial Departments, Public Sector enterprises, Bank & Insurance;

   (c) All medical services (to be defined in consultation with the Health Ministry);

   (d) All school and college education;

   (e) Any service transactions between an employer and employee either as a service provider, recipient or vice versa;

   (f) Unprocessed food articles;

   (g) Life saving drugs and equipment; and

   (h) Equipment used in national security functions.

8. Commodities like petroleum crude and products, natural gas and tobacco should be subject to Central-GST at higher rates. Further, no input tax credit should be granted to the purchasers of these commodities on administrative considerations. Effectively, such a levy would amount to an excise.

9. Typically a small number of firms account for a large proportion of revenues from taxes on goods and services. Simultaneously, resources used in the collection of taxes are scarce and must therefore be deployed effectively; these need to be concentrated on the largest taxpayers as part of the risk management strategy. Further, the compliance burden under the invoice credit method is relatively high and it is uneconomical to collect revenues from a large number of small taxpayers. Hence, keeping in view the compliance cost and administrative feasibility, small dealers (including service providers) and manufacturers should be exempted from the purview of this tax by prescribing a threshold exemption limit up to Rs 25 lakh in annual turnover. However, like in most other countries those below the threshold limit may be allowed to registered voluntarily to, facilitate sales to other registered manufacturers/dealers, limit competitive distortions and avoid inequities.

10. A compounded levy at the rate of 2 per cent could be levied on small dealers with annual turnover up-to Rs. 40 lakh. However, no input credit should be allowed against the compounded levy or purchases made from exempt dealers.

11. All dealers/producers with annual turnover exceeding Rs. 40 lakh should be required to compulsorily register with the tax administration and liable to the integrated goods and services tax. This limit has been fixed keeping in view the fact that such taxable entities are subject to tax audit under the Income Tax Act, and therefore may not have to bear any significant additional compliance burden.
12. The unit of taxation for the purposes of this levy should be persons as defined under the Income Tax Act and not production units/branches.
13. The administration of this levy should be based on audited accounts and not on the basis of any form of physical controls.
14. The dealer/manufacturer liable to Central-GST should be required to be registered with the tax administration by obtaining both PAN and TAN which together should form his unique business identification number.
15. The registered taxpayer should be required to make payment of taxes and filing of return on a monthly basis. However, taxpayers opting for the compounded levy should be required to pay their taxes and file their returns on a quarterly basis.
16. Best international practices should be embedded in the Central-GST, particularly in respect of laws relating to levy of penalties, and circumstances and method of prosecution and preventive arrest/detention.
17. The tax administration responsible for Central-GST must ride on the newly developed OLTAS of the Income tax Department to collect information relating to payment of taxes from the banks. No new and separate IT infrastructure for managing payment information flows is necessary.
18. In a VAT-type Central-GST, it is necessary to establish an information system which will enable verification of transactions and input credits so as to prevent fraud and leakage of revenue. Under the TDS system prevailing in a income tax regime, one of the parties to the transaction, acting as the agent of the government, collects tax from the other party i.e. the taxpayer, and is responsible for depositing the tax with the government and filing a TDS return to furnish information relating to such transactions. The taxpayer is entitled to claim credit for taxes 'paid' to the agent.

    The input credit system under a VAT is no different from the TDS system. Therefore, all registered taxpayers should be mandated to file a monthly information return (along the lines of the TDS/annual information return under the Income tax Act) detailing all transactions relating to sales and purchases of goods and services.

    The tax administration for Central-GST can very easily ride on the newly developed Taxpayers Information Network (TIN) of the Income tax Department to collect and collate monthly information returns. There is no need to create a new and separate IT infrastructure for managing input credit information flows. The newly developed TIN will be a taxpayer friendly system and will enable taxpayers to obtain input credits without incurring difficulties in verification.

The fully integrated goods and services tax outlined above should be implemented through a new legislation known as the *Indian Goods and Services Act*, effective from 1st April, 2005 to replace the Central Excise Act and service tax levied under the Finance Act, 1994. This legal framework will be consistent with the best international practice. Since a new legislation for a comprehensive goods and services tax cannot be effective before 1st April, 2005, as an interim measure towards integration, input credit across goods and services should be allowed.[7]

[7] This proposal forms part of the Finance Bill, 2004, proposed in 8 July 2004.

5.3.4 Constitutional power to levy integrated goods and services tax

It has been widely recognised by legal experts that a tax on all services should not be levied by the central government under its residuary powers. It would be appropriate if the comprehensive levy was imposed in exercise of an explicit taxing power conferred under the Constitution.

Accordingly, the Constitution (Eighty-eighth Amendment) Act, 2003 (see Appendix D) inserted Entry 92C empowering central government to levy tax on all services. This amendment also mandates that the power to collect this levy will vest both in the central and the state government. Through Entry 84 of the Union List of the Seventh Schedule of the Constitution of India read with the new Entry 92C of the Union List, as inserted by the Constitution (Eighty-eighth Amendment) Act, 2003, the central government now has the power to levy tax on a tax base comprehensively extending over all goods and services and going up to the final consumer.

In other words, the post manufacturing value addition, hitherto exempt from union excise duties, can now be subject to the levy of service tax. Therefore, the central government now has the explicit powers to levy tax at all stages of production and distribution of goods and services leading to its final consumption. Since final consumption of the goods and services arises at the point of sale, effectively, the central government now has the power to tax sale of both goods and services. However, at present the power of the state government is restricted to sale of goods only.

5.3.5 Treatment of capital goods

In the past, a number of countries, introduced accelerated depreciation or investment allowance to compensate for domestic trade taxes paid on capital goods. With the gradual introduction of VAT and the feasibility of extending credit for VAT on fixed assets,[8] depreciation rates were rationalised. Later in some countries, VAT was used to slow down the development of capital intensive production processes. To this end, they disallowed the credit for the VAT on fixed assets (defined as all assets which are subject to depreciation) and non-material assets, like technical know-how.

The case for allowing full and immediate credit for the VAT on capital goods rests on several arguments:

1. Depending on the capital intensity of the production process, the VAT on fixed assets enters into the price, causing uneven effects on consumer prices.
2. Any kind of restriction on full and immediate credit for VAT on fixed assets deters investment and hampers technological change, unless it can be fully shifted forward to consumers.[9]
3. Limiting the credit for VAT on fixed assets in any manner results in increased cost of exports thereby undermining international competitiveness. Hence, it serves as a disincentive to exports.
4. Capital goods need to be defined thereby creating scope for considerable disputes.
5. Denial of immediate credit for VAT on capital goods leads to implicit taxation. This is further

[8] Other reasons for rationalizing the depreciation rates were significant control over rate of inflation in the price of capital goods and reduction in corporate tax rates.

[9] However, forward shifting is unlikely if competing imports can be sold without the element of tax on capital goods.

> aggravated if excess credits are not refunded but must be applied against VAT on future sales. Further, in the face of inflation, the real value of the tax credits carried forward declines rapidly becoming equivalent in effect to a tax on fixed assets. Any denial of full and immediate credit for the VAT on capital goods violates the neutrality of VAT.

Therefore, in recent years, most countries have introduced a full and immediate credit for the VAT on capital goods applied for the purpose of registered businesses.

Under the Central Excise Act, credit for CENVAT paid on capital goods or CVD on imported capital goods is spread over two years resulting in the kind of distortions discussed above. The rationale for this spread over is essentially loss in revenues. The estimated total credit for CENVAT paid on capital goods and CVD on imported capital goods in 2002-03 was Rs. 8,500 crore and could be expected to increase to about Rs. 9,000 crore in 2004-05. Since the credit is allowed over a period of two years, the loss in revenues is, therefore, estimated to be Rs.4,500 crore and restricted to the transitional year only. However, in the context of revenue gain from reduction in depreciation rates proposed in the section on corporate tax, the impact on revenue could be fully absorbed.

In the light of the arguments in support of full and immediate credit for VAT on capital goods and the revenue implications thereof, we recommend the full and immediate credit for integrated GST on capital goods (including GST on imported capital goods) in the year in which capital goods are acquired. Further, any kind of transfer of the fixed asset at a later stage should also attract GST liability like all other goods and services.

5.3.6 Treatment of petroleum products

One of the classes of products whose consumption needs to be checked to restrict negative externalities is petroleum products. Therefore, petroleum products enjoy a very special excise duty regime: the basic rate of duty is the same as the CENVAT rate, but there are other duties/levies loaded on it as indicated in Table 5.3. CENVAT credit is also not allowed in the case of most petroleum products which are used both as intermediate input and in final consumption. After the dismantling of the APM, oil companies now decide on the price periodically taking into account the behavior of the international oil market. As and when prices fluctuate, it is expected that domestic prices would also be fixed accordingly. Price adjustment must only reflect the ‘pure’ effect of international price fluctuation. This should not be used as an opportunity to raise tax revenues.

The levy of duties on petroleum at *ad valorem* rates induces oil price risk for government revenues: if a revenue target for the future is fixed when oil prices are ruling high, government could miss the target when prices drop and be forced to consider ad hoc measures. A specific rate of duty helps in avoiding such situations. It is important to ensure stability in the flow of revenues from the oil sector. Further, periodical revisions in the prices make administration of ad-valorem levy difficult. Specific duties would facilitate assessment; the need for ascertaining the market cost, inland freight, margin, etc. would also be obviated. In any case these products are already being subjected to cesses/ surcharge, which are specific, and, therefore, it will be convenient if the CENVAT component which is *ad valorem* is also converted into specific rates.

Table 5.3 Excise structure for petroleum and natural gas (1 June 2004)

Product	Basic	Special	Addnl.	Special Addnl.	CENVAT credit
Motor Spirit (Petrol)	16	14	Rs.1.50 per ltr.	Rs.6 per ltr.	No
Refined Diesel (HSD)	14		Rs.1.50 per ltr.		No
Light Diesel Oil	16		Rs.1.50 per ltr.		No
Other Diesel Oil	16		Rs.1.50 per ltr.		Yes
Kerosene	16				Yes
Furnace Oil	16				Yes
LPG and other gases	16				Yes
Other petroleum products	16				Yes
Natural Gas					–
CNG	16				–

The present cesses/ surcharge could also continue at specific rates.

In view of the above, we recommend that the *ad valorem* rates of excise duties applicable to petroleum products should be converted into specific rates. There are alternative ways of making such conversion. In addition to the basic excise duty, other levies like special excise duty, additional excise duty and special additional excise duty, wherever applicable, should continue.

5.3.7 Treatment of small-scale sector

Since excise is a duty on manufacture, it is payable even by a small unit manufacturing goods. At present, the small-scale sector with over 40 lakh units spread all over the country accounts for nearly 95 per cent of industrial units in the country and 40 per cent of the value added in the manufacturing sector. Its share is as high as 34 per cent in national export and it contributes roughly 7 per cent to the country's total GDP.

Yet its contribution to excise revenue is negligible, only of the order of 3.4 per cent of the total excise revenue. This is due to the fact that the small scale industries sector enjoy exemption from payment of excise duty on their final products up to an annual turnover of Rs. 1 crore but are also denied the benefit of input credit.

Effectively, the tax paid by the SSI sector was restricted to the tax paid on inputs; the exemption was restricted only to the tax payable on the value addition. The theoretical underpinning for such an exemption was high administrative and compliance cost in relation to the economic value of taxes which would otherwise be collected from the small scale industries sector.[10] However, the situation has got aggravated with SSI units being given the option of payment of excise duty on their final product up to an annual turnover of Rs.1 crore, at a concessional rate of duty equal to 60 per cent of there normal duty[11] and also avail the benefit of input credit. In

[10]Compliance cost of SSI (i.e. Salary, time spent by management etc., stationery, legal adviser, litigation etc.) as a percentage of duty paid was found to be 4.68% in 1993-94 in case of small scale industries. However, it was hardly 0.084% in case of large assesses whose value of goods were over Rs. 200 crore. Time spent by top management with legal adviser and in litigation matters was also higher than average in case of small industries. Thus, burden of additional costs for payment of duty is disproportionately high on small firms.

[11]With the present rate of duty at 16 per cent, such units are allowed to pay excise duty at the rate of 9.6 per cent.

effect, the SSI units have been conferred the benefit of zero rating whereby the duty paid on inputs is refunded. Most committees have, in the past, recommended the rationalisation of this regime due to the following adverse consequences flowing from this special excise regime:

1. The adverse impact on the tax to GDP ratio is an undeniable outcome of the increasing exemption limit for this sector;

2. Central excise being a tax at first stage of production, the exemption therefore leads to non-accountal of production which leads to non-payment of all other taxes (Income Tax, Sales tax etc.) and generation of black money;

3. Exemption leads to misuse of CENVAT credit by the duty paying (large) sector which procures the exempted goods from SSI sector but wrongly takes credit on basis of duty payment documents generated elsewhere;

4. Non-accountal of transactions encourages a cash economy with its own adverse implications;

5. The exemption gives benefit to units up to a specified turnover after which, duty has to be discharged at the full rate. Therefore, for obvious reasons the units prefer to keep their turnover within the full exemption limit, either by unaccounted removals or by horizontal proliferation. This is not desirable from the point of view of evasion of tax. It also discourages economies of scale;

6. Duty exemptions for the SSI sector constitute a break in the CENVAT credit chain and would adversely impact the adoption of a full fledged VAT; and

7. An exemption leads to loss of valuable data which proves counterproductive in respect of dissemination of information, tax planning etc.

In view of the above we recommend that the threshold exemption for small scale industries should be reduced from Rs.1 crore to Rs.40 lakh. Further, in respect of clearances between Rs. 40 lakh and Rs. One crore, they should have the option to pay duty at the rate of 4 per cent (without credit for integrated GST paid on inputs) or at the standard GST rate and claim credit for GST paid on inputs. This threshold exemption limit should be based on the value of total clearances (including exempted but excluding export clearances). Further, in order to reduce compliance cost, the small scale units may be required to make payment of taxes and filing of returns on a quarterly basis.

The threshold limit has been fixed keeping in view the economics of optimal threshold and the fact that such taxable entities are subject to tax audit under the Income Tax Act, and therefore may not have to bear any significant additional compliance burden.

5.3.8 Location based exemptions

Another important source of distortion and leakage of revenue is the location based exemption. This was first introduced in 1999 in respect of north-eastern states but has since then expanded to include the Kutch district in Gujarat, Jammu and Kashmir, Uttaranchal and Himachal Pradesh.

The location based exemption has led to competitive demands by other states for similar exemption. Some states have been complaining of deindustrialisation i.e. Firms being shifted out to neighboring states enjoying location based exemption. Tax administration has found growing instances of shell companies leading to fraudulent exemption claims and loss of revenue without any comensurate social benefit. The problem is further compounded by the policy to allow deemed credit in respect of purchases from units located in such exempt areas.

In view of the foregoing, we recommend that:

1. The area based exemption should be grandfathered to units already established.
2. Deemed input credit on purchases from exempt areas should be withdrawn.

5.3.9 Treatment of immovable property

The construction and exploitation of real estate comprises one of the larger sources of gross domestic product. It is one of the drivers of economic growth with large employment potential. Expenditure on housing also constitutes a significantly large proportion of total personal consumption expenditure. Therefore, this sector must form part of the tax base for any value added tax or its variant.

Real estate is subject to multiple taxation both at the central and state level. Most inputs used in the real estate industry are liable to CENVAT with no corresponding benefit for input credit since the output is exempt from CENVAT or service tax. This has given rise to a flourishing invoice trading industry encouraging fraudulent claims of input credit. Further, in the absence of any input credit, there is no incentive to the purchaser to obtain an invoice. Consequently, the audit trail of such transactions is lost and producers of inputs are also encouraged to suppress such transactions. The problem is further compounded by the levy of ”sales tax” on works contract (with no credit for sales tax paid on inputs) and the imposition of stamp duty.

These three taxes – CENVAT on raw materials, sales tax on the works contract and stamp duty – all constitute incentives to transact using ‘black money’. They constitute a major part of the explanation of the substantial use of black money in the real estate sector.

Registration and stamp duties exhibit the same distortionary cumulative and cascading effects as excises. These taxes can be viewed as a proxy for the VAT that should have been levied on the increase in the value of immovable property realised at the time of sale. This increase represents the capitalised value of the increase in the value of the services of the immovable property that belongs in the VAT base.

In most states, the statutory rates of stamp duty on immovable property transaction are high. Therefore, the effective rate on value-addition is exorbitant, thereby encouraging under-reporting of transactional value and evasion of stamp duty. Since stamp duties are directly or indirectly related to other taxes, any stamp duty evasion triggers a similar response to compliance with other taxes. As with other transaction taxes, it generates a bias in favour of not selling, and inhibits the development of a liquid secondary market.

In the context of a distortionary tax regime governing the real estate industry in India, there is a strong tendency for this industry to remain outside the organised sector and consequently the regulatory framework. Therefore, it serves as a breeding ground for tax evasion and criminal activities.

Rationalisation of the tax regime governing the real estate industry is thus an area where policy initiatives could yield numerous benefits : Fair taxation of real estate with tax credits for raw materials as is the case for any other industry, improved tax compliance in the property tax which is critical for the revenue base of local government, a reduced

Box 1: Registration and stamp duties

Registration duty or fee is a payment made for a specific service provided by government in recording contract and deeds. The government maintains a registry of deeds in return for a fee. Government agents (called 'sub-registrars') do not verify the legal validity of documents; they only focus on the correct payment of the fee. The payment of the registration fee does not entitle the payee to a guaranteed legal title.

Stamp duty is a tax on the value of instruments used in various transactions. It is a 'Tobin tax', a 'transaction tax' and a 'turnover tax'.

Stamp duties are also directly or indirectly related to a number of other taxes.For example, the value of the transaction affects the individual income tax via the inclusion of short-term and long-term capital gains in the income tax. Similarly, valuation impacts upon the individual's tax liability in the gift tax, as well as in the wealth tax. The property tax in most urban areas is based on the annual rental value of a property. Nevertheless, the annual rental value of a property is, or should be, closely related to its capital value, as revealed in the market sale of the property.Indeed, many urban local bodies use market values as "guidance values" in establishing annual rental values for different types of properties in different locations within the jurisdiction, and some are also experimenting with the move to a property tax based on capital value.

In all of these cases, the declared value of the transaction as used to calculate stamp duties has direct relevance to the tax base used to calculate these other taxes.However, the existing system of tax administration does not make links between the transaction value shown for stamp duty purposes and these other tax obligations. It is also possible that State sales and excise taxes are affected in more indirect ways by the declared value of the market transaction.

role for black money, and a reduced role for the criminal element in the real estate sector.

At a conceptual level, under a VAT, sales, rentals, and rental values of immovable property would be taxable and credit would be available for the VAT embedded in purchases. Immovable property that generates housing services should be treated in the same manner.

The theoretically most attractive solution would be to register all legal persons, who own or buy residential real estate, for VAT purposes. By purchasing a dwelling, these persons would become producers of housing services. In their role as producers, they would subsequently sell the housing services to consumers. These consumers could be lessees who buy the services for consideration, i.e., a rental charge. It is also possible that producers would put the dwelling at their own disposal. In other words, as owner-producer they would "sell" the housing services to themselves in their role as occupier consumers. Therefore, the purchaser of an immovable property could use the housing services produced from ownership either for self-consumption or for 'sale' by renting out the property.

The VAT consequences of these events are as follows. On purchase of a bundle of housing services in the form of dwelling, the registered taxpayer pays tax on the purchase price, but at the same time, he is entitled to a tax credit (and refund, if due) for the same amount. If he sells the housing services to lessee, he would have to charge VAT on the amount of the rental. The lessee being an unregistered consumer, would not be able to pass the tax on; he would be stuck with it just like consumers of other services. Similarly, in his role as owner-occupier, the producer of housing services would ”charge” VAT on these services, whose value equals the rental value of the dwelling rendered to himself as consumer. And like the lessor, he would have to remit that tax (net of any tax on inputs, such as repair and maintenance services) to the government.

In practice, the registration of all owner-occupiers and the computation of all imputed rental values presents formidable administrative problems and is therefore not feasible. If imputed rental values cannot be taxed, the taxation of rental charges would appear to favor owner-occupiers over lessees. Further, the practical difficulties of taxing small landlords might be severe. As a second-best approach, therefore, nearly all countries with a VAT exempt imputed rental values as well as rental charges on residential property. Since the purchase price of a house may be taken to represent the capitalised value of its future services, the tax on the purchase price may be considered a proxy for the capitalised value of the tax that should have been levied on the flow of housing services, these countries tax new residential construction.

A cross country survey of the design of VAT on immovable property indicates that countries with a VAT apply this second-best solution to housing services(exemption of rents and rental values, taxation of newly created houses). This broadly satisfies generally accepted criteria of horizontal equity, neutrality and feasibility.

Two broad implementation approaches to this second best solution have been followed: the *exemption method* and the *tax method*. The tax method works by taxing all immovable property but exempting housing services,[12] and exempting the sale of any residential properties that existed prior to the date of introduction of the VAT. The exemption method exempts all immovable property except for new dwellings. The VAT treatment of immovable property under these two approaches is summarised in Table 5.4.

Further, since commercial uses (of both existing and new properties) and sales of existing immovable property are exempt under the exemption method, an opportunity is provided for optional registration and payment of tax on the commercial use and sale of immovable property to avoid potential discrimination and cumulation of tax. However, under the tax method optional registration and payment of VAT is not an issue.

It is well accepted that the tax method is superior to the exemption method. Under the tax method, commercial exploitation of immovable property, not being houses, is fully taxed. Under the exemption method, increases in the value of commercial housing services are not taxed. Moreover, optional taxation causes differential effects. More generally, under the philosophy of the VAT, it is better and easier to define selective exemptions than to define selective charges to tax. Further, in the immovable sector also, good (buildings) and services (renting) have become nearly perfect substitutes. Equal treatment is nearly fully achieved under the tax method.

Therefore, we recommend the following strategy for integrating the real estate sector into the Central-GST:

[12] Housing services refers to services derived from residential property.

Table 5.4 VAT treatment of immovable property under two approaches

Nature of transaction	Exemption Method	Taxation Method
A. Existing residential property stock		
i. Sale	Exempt	Exempt
ii. Rental charges	Exempt	Exempt
iii. Imputed rental values	Exempt	Exempt
iv. Alteration and maintenance	Taxable	Taxable
B. New residential property		
i. Construction/ First Sale	Taxable	Taxable
ii. Resale	Exempt	Exempt
iii. Rental charges	Exempt	Exempt
iv. Imputed rental values	Exempt	Exempt
v. Alteration and maintenance	Taxable	Taxable
C. Existing commercial property stock		
i. Sale	Exempt	*Taxable*
ii. Rental charges	Exempt	*Taxable*
iii. Imputed rental values	Exempt	Exempt
iv. Alteration and maintenance	Taxable	Taxable
D. New commercial property		
i. Construction/First Sale	Taxable	Taxable
ii Resale	Exempt	*Taxable*
iii. Rental charges	Exempt	*Taxable*
iv. Imputed rental values	Exempt	Exempt
v. Alteration and maintenance	Taxable	Taxable
E. Building materials	Taxable	Taxable

1. Since stamp duty can be viewed as a proxy for the service tax that should have been levied on the increase in the value of immovable property realised at the time of sale, it is necessary to remove the existing stamp duty to facilitate input credits and eliminate cascading effects.

2. The Central-GST should apply for all newly constructed property (residential or commercial). If it is self-used by the person who constructed it, the Central-GST should be applied on the cost of construction. If it is sold or transferred, the Central-GST should be applied on the consideration received at first transfer or sale. In both cases, obviously, credits would be obtained for the Central-GST embedded in the raw materials used in construction.

3. Rental charges received (excluding imputed rental values) in respect of leasing of immovable property used for commercial purposes should be charged to Central-GST. However, rental charges or imputed rental values of residential properties should be exempt from Central-GST.

4. All secondary market transactions in immovable properties should be liable to pay the GST on the difference between the sale proceeds and the purchase price. This payment would be borne by the purchaser of the immovable property.

5. The proceeds from the levy of Central-GST on immovable property will form part of the divisible pool.

6. The State performs essential asset registry functions, and enforces property rights associated with them. These functions are comparable to those of a depository on the markets. The registration fees can be interpreted as user charges for these record keeping functions – which justifies small charges such as NSDL's charge of Rs. 6 per transaction. The imposition of large-

> scale indirect taxes through registration and stamp duties constitutes a case of erroneous tax policy. Therefore, States may continue to levy a registration fee at a specific rate not exceeding Rs 200 per transaction in immovable property, which is merely a user charge for the IT systems used in property registration.

A major strength of the GST lies in its ability to solve long-standing puzzles which has been vexing traditional tax policy approaches. The real estate sector serves as a prime example. This sector has long been a problem in Indian tax administration, and has been an area plagued by black money distortionary taxes underworld elements, etc. The Central-GST offers a sound and sensible framework, where compliance is incentive compatible for market participations, through which this important sector can be converted into a part of the legitimate economy, with taxation being applied as a level playing field.

The impact of integration of the real estate sector into the Central GST may perhaps set the stage for transforming that sector in a way that is reminiscent of the aftermath of opening up to gold imports in the 1990s.

5.3.10 Treatment of financial services

The financial industry includes commercial and savings banks, credit unions, insurance companies, pension funds, and brokerages. The taxation of finance companies is in many respects similar to the taxation of other business sectors; nevertheless, it poses specific problems that require separate consideration.

The treatment of finance companies under a VAT is a complex issue. Under a well-designed tax system, a VAT would apply to all forms of consumption, including financial services. It is, however, difficult in practice to apply a VAT to financial services primarily because of the difficulty in measuring value added associated with financial services.

In principle, it is possible to measure value added in the banking sector by adding profits, wages, rent, and interest or, alternatively, by taking the difference between investment income and the cost of funds (interest expense plus the cost of equity financing) and other cost of the bank.

The application of the invoice system, however, requires that the VAT liability be attributed to each transaction. This is not possible in the banking sector because most financial services provided by banks do not have specific charges attached to them. Instead, charges for services result from differences in interest rates charged to borrowers and those paid to lenders. Even charges for some services, such a checking account activities, that could be separated from financial intermediation activities are often reflected in interest rates.

With respect to insurance companies that provide casualty insurance (and other forms of non-investment insurance), value added is measured by the loading charge, essentially the earnings of the insurer over and above payments of claims. Value added is not properly measured by the value of premiums or claims, since this includes the component of premiums that is a re-distribution from one policyholder to another (e.g., when one policyholder makes a claim, there is a redistribution to that policyholder from other policyholders). For insurance with an investment component, the value added is again only properly measured by the loading charge, not the savings component. In either case, it is difficult to measure the loading charge, making it difficult to apply VAT to insurance activities.

There are three alternative methods for including the finance industry in a VAT: the exemption method, the zero-rating method and the full taxation method.

Most countries with an invoice method VAT have chose to exempt financial companies. The advantage of the exemption method is that many financial services are provided to business that are taxable under a VAT, ensuring that these services are taxed, in effect, even if financial companies are not subject to VAT. Since exemption does not allow firms to credit VAT paid on inputs, however, some cascading occurs with respect to financial services provided to businesses that are taxable under a VAT. Exemption does allow service provided to households and businesses that are not taxable under a VAT to escape tax, although the inability to credit VAT paid on input results in some VAT burden. Exemption puts domestic financial companies at a disadvantage relative to offshore institutions, if exports of financial services are zero-rated. Exemption may also encourage financial companies to produce some intermediate goods themselves, rather than purchasing them, since they could not credit VAT on these purchases.

Finally, if financial companies are only partially exempt, this creates problems apportioning VAT paid on inputs to taxable and non-taxable items and could make the tax more vulnerable to tax evasion schemes.

The advantage of the zero-rating method is that it avoids many of the problems with exemption, but it has the disadvantage of generating less revenue and lower the tax burden on financial services compared with other consumption activities.

The advantage of the full taxation method i.e., incorporating financial companies into a VAT, is that it enhances the tax base quite considerably and also results in an equal treatment of financial services and other business services.

The alternative approaches to full taxation that have been considered include the addition method, the subtraction method, the optional method and the cash flow method.

Under the addition method, tax is levied directly on the sum of wages and profits. Israel taxes banks in this way. The addition method, however, does not solve the cascading problem because the VAT cannot be passed on to business users of financial services on a transaction-by-transaction basis.

Under the subtraction method tax is levied directly on an accounts based measure of value added calculated by subtracting allowable purchases from revenues.

Both the addition and subtraction method are capable of taxing aggregate value added in the financial sector and would in principle be consistent with a wider VAT system based comprehensively on addition or subtraction method. However, these methods would not fit well with the application of the invoice-credit method in the rest of the VAT system since they do not enable the identification of embodied VAT on a transaction-by-transaction basis so as to allow the systematic crediting of input tax in respect of financial services availed by registered traders.

In principle, the difficulties encountered under the different methods can be circumvented by applying VAT on a ”cash flow” basis. Under the cash flow approach, cash inflows from the financial transactions (deposits, interest receipts) are treated as taxable sales and cash outflows (loans, interest payments) are treated as purchases of taxable inputs. The VAT on these inputs along with the VAT on inputs in turn, would constitute input tax credits for other taxable persons involved in industry and trade (or, for that matter, banking). At the same time, of course, these taxable persons would pay VAT on their inflows, i.e. Loans extended by banks. As a result, tax cascading, inherent to the exemption approach would be avoided, while consumers would be taxed in full.

The pure cash flow method, however, is not directly equipped to deal with tax-rate changes. Also borrowing requirements would increase because taxable persons taking out loans would have to finance the VAT on the loans. Beyond that, compliance costs, especially for small and medium-sised business would increase because non financial business would be required to carry out various calculation in order to obtain input tax credits for financial services purchased. To resolve these problems, a tax calculation account (TCA) would have to be introduced, to be administered by financial companies (and not by non-financial business).[13] Currently, the application of this method is being tested in various pilot projects across EU.

In deciding the scope and design of VAT on financial services, certain characteristics of the economy and the financial sector will need to be taken into consideration. The relevant considerations will vary from country to country. In making the choice, it is important to consider compliance and administration issues and the extent to which taxation versus exemption will create competitive distortions and significant behavioral changes. Some factors that are problematic in developed economies may raise less difficulty in developing countries.

In developing countries, taxation of financial services is viewed as progressive because such services as banking, brokerage, property and casualty insurance, and foreign exchange transactions are connected closely with those with income and wealth. This has certainly been a major consideration in the decision of the Government of India to extend its service tax to a variety of financial and other services, including share brokerage and insurance. Generally, where an exemptions is in place under a VAT, there will likely be less revenue than under full taxation.

The progressive revenue objective thus dictates as wide an application of VAT to financial services as possible. It also encourage countries to consider compensatory taxes where an exemption must be provided and even additional ad hoc taxes for revenue purposes. Therefore, given the progressive nature of taxation of financial services and the distortionary impact of compensatory and ad hoc taxes, we would recommend the following scheme of treatment of financial services under the proposed integrated GST:

1. The scope of this scheme will extend to the following categories of financial service providers: All regulated finance companies registered with the Reserve Bank of India, IRDA, PFRDA, FMC, and stock exchanges registered with SEBI. This includes banks,

[13] The introduction of a TCA involves the choice of the appropriate indexing rate, single or composite (reflecting different maturities of loans and deposits), and the frequency of the indexing adjustments require further study. Administrative issues that need to be addressed concern the valuation of financial assets and liabilities required at the time of commencement of the cash flow method and at the time of VAT rate changes, as well as the proper definition of financial companies permitted to keep TCA accounts.

brokerage firms, insurance companies, primary dealers, pension fund managers, etc.

2. These financial service providers will be required to separately register with the tax administration (Central Excise Department).

3. The tax base for levy of the GST on financial service providers will be determined by the subtraction method. The value added by each taxable entity will be account based and calculated by subtracting allowable purchases from net revenues.

4. Allowable purchases would mean all purchases of revenue or capital nature on which integrated GST has been paid or deemed to have been paid in accordance with the provisions of the law and eligible for credit for such taxes.

5. Net Revenues would mean all receipts in the nature of income including receipts from sale of assets as reduced by the amount of service tax deemed to be included therein. Revenues from farm loans, home loans, loans to non-profit organisations, student loans and commercial loans to all registered GST taxpayers should also be excluded.

6. The registered financial service provider will not be required to separately indicate on any invoice, either on a transaction-by-transaction basis or otherwise, the amount of service tax charged by it.

7. Any financial service provider with an annual revenue of less then Rs.25 lakh will be exempt from the levy of integrated GST and will therefore not be required to be registered with the tax administration. Further, a compounded levy at the rate of 2 per cent would be levied on those with annual turnover up to Rs.40 lakh and will not be allowed the benefit of claiming credit for GST paid on inputs. However, they will have the option to register and follow the discipline of the integrated GST.

8. The purchaser of the financial services will be entitled to claim a constructive credit i.e., deemed credit only in respect of services received from the registered financial service provider. However, this will not be available in respect of farm loans, home loans, student loans, commercial loans availed by registered GST taxpayers and loans availed by non-profit organisations.

The above scheme which provides for deemed credit to registered purchasers will eliminate the problem associated with the application of the subtraction method for full taxation of financial services. To the extent the financial services are availed by final consumers, the GST will "stick" to such consumers. Further, since the financial service providers are highly "concentrated" (i.e., limited in number), the subtraction method will enable the government to obtain sound enforcement from a small number of taxpayers thereby limiting administrative cost.

5.3.11 Treatment of imports

The customs duty to GDP ratio was 1.8 percent in 2003-04 and is amongst the highest in the world. However, customs duty revenues in India includes countervailing duties (CVD) which accounts for about 0.6 percent of GDP. CVD is internationally comparable to VAT on imports and internationally these are reported as part of revenues from VAT and not as part of customs revenues. To this extent, there is over-reporting of customs duty to GDP ratio.[14] Even after adjusting for CVD, the customs to GDP ratio continues to be extremely high by international standards.

It is now well recognised that consumption

[14]While CVD collections are classified as customs duties, the input credit for CVD is accounted under union excise duties. Therefore, the collections under the head union excises are under reported. Adjusted for this misclassification, the effective buoyancy of union excise duties would be substantially higher than the reported buoyancy.

taxes must be designed on a destination principle. As a result, exports are zero-rated since the place of consumption is in the importing state. Consequently, imports are subjected to consumption tax. The rate at which the VAT on imports is imposed generally reflects the effective burden of all domestic taxes levied at both federal and state levels. It is always collected at the customs point on the international border to prevent any leakage of revenues. Therefore, in most countries operating a national VAT, the VAT on imports is applied at the rate applicable to the domestic consumption of the same product as if it was domestically manufactured. However, where there is both a federal and a state level VAT, as in Canada, the VAT on imports is charged at the combined applicable rate of federal and state VAT.

In India, the problem is quite complex. This arises both from the central government levy on consumption (i.e. CENVAT) and the structure of state level levy in the form of retail sales tax, CST, entry taxes and octroi duties. The Central Government levies a CVD on imports which is equivalent to the CENVAT rate applicable to the same commodity manufactured in India. In a large number of cases where the goods are not manufactured in India, imports of such goods are exempted from CVD. Essentially, CENVAT is viewed as a production tax and CVD as providing a level playing field to domestic manufacturers. It is argued that if the commodity is not manufactured in India, there is no case for providing any kind of a level playing field.

This argument is flawed. CENVAT should be essentially viewed as a federal level consumption tax collected/levied at the point of manufacture. Since all imports are meant for consumption in India, they should be liable to CENVAT and all other state level taxes levied on consumption. Further even if it is accepted that CENVAT is indeed a production tax, the objective should be to create an environment of level playing field for a potential domestic manufacturer. Therefore, the appropriate principle in such a case should be 'as if the import was manufactured at the border'. In either case, exemption from CVD is not justified.

The structure of the state level consumption tax is not designed along the lines of a modern VAT. Where the transaction is between two registered dealers in the same state, the transaction is exempt from state level sales tax. If the transaction is between two registered dealers across states, the transaction is subjected to a concessional levy of 4 percent towards central sales tax (CST). If the transaction is between a registered dealer and an unregistered dealer or final consumer, within the state or across, there is no concession and sales tax is charged at the applicable rate. Given the variation in the tax treatment of domestic sale transactions, any design of CVD or VAT on imports must necessarily reflect these variations. At present, the CVD on imports does not include state and local taxes. These levies are embedded in the rates of basic customs duty. Adjusting for these levies, the rates of basic customs duties in large number of cases would be comparable to international standards.[15]

In view of the foregoing, we recommend the restructuring of the countervailing duties along the following lines-

1. CVD should be replaced by a separate two part levy on imports: the first part should reflect

[15] In some cases, there could be negative protection.

the proposed Central-GST and the second part must reflect the state-level GST.

2. The collections under both the parts should be separately accounted.

3. All imports should be charged to the proposed Central-GST and state-GST at identically the same rate applicable to consumption of domestic goods. If the domestically produced good is exempt from the proposed Central-GST or State-GST or charged at lower rate, the imported good must also enjoy the same treatment. There should be no exemption on the ground that the goods are not being produced domestically.

4. If the imported goods and services are used as intermediate inputs in production or distribution, credit for the proposed Central-GST and state-VAT on imports should be allowed against the Central-GST and state-GST on the final products, respectively.

5. The revenues collected from Central-GST on Imports will form part of the divisible pool to be shared between the Centre and the State at the appropriate rate.

6. The revenues collected from State VAT on Imports will be assigned to the state of import destination.

7. Since exports will be zero rated under the proposed Central-GST, an exporter may either claim credit for payment of Central-GST on imports against Central-GST liability on domestic output or claim of refund of Central-GST on Imports if it is greater than the Central-GST on output. Similar treatment should be accorded to exporters in respect of state-level GST on imports by the concerned state tax administration under the scheme of zero rating of exports.

8. Since refund of input taxes in the nature of GST embedded in the exports would be processed as part of the normal assessment of the taxpayer's return, the scope of the duty drawback scheme should be restricted to basic custom duties.

5.3.12 Power to tax services: sharing it with the states

Entry 84 in the Union List in the Constitution of India empowers the central government to levy duty of excise on goods manufactured, thereby excluding services by implication. However, many activities in manufacturing partake of the character of services and therefore, it was possible to minimise excisable value and thereby avoid the tax by labelling such activities as packaging and splitting it from manufacturing.[16]

Faced with this problem the central government expanded the definition of manufacturing to include even labelling and relabelling. Tax on selective services[17] did not include the services of the type rendered in the post-manufacturing stage to the point of retail sales.

As a result, determining the excisable value of the manufactured goods has posed intractable problems leading to considerable dispute. This was sought to be overcome by resorting to the maximum retail price with appropriate abatement for value addition in the distribution stage, as a proxy for the value of the good up-to its manufacturing stage. The abatement for value addition in the distribution stage differs across categories of goods, thereby, neutralizing the beneficial impact of progressive reduction in the dispersion of rates.

The Constitution has now been amended vide the Constitution (Eighty-eighth Amendment)

[16]Based on judicial pronouncements, the term "manufacturing" is now understood to mean only physical transformation of a commodity from one form to another.

[17]This was introduced in 1994 by the Union Government in exercise of its residual power under entry 97 in the Union List.

Act 2003 (see Appendix D), to enable the Parliament to formulate, by law, principles for (i) determining the modalities of levying the service tax by the central government, (ii) collection of the proceeds by the centre and the states and (iii) sharing of the proceeds between the centre and the states.

On the face of it, it would appear that the contemplated legislation follows the lines of the Central Sales Tax Act of 1956 which enable the centre to levy the tax on services but allows the states to implement taxes on some of the services and appropriate the revenue on origin basis. However, the revenue realised from the tax on services, even if collected by the states, would have to go into the divisible pool.

With explicit powers to levy tax on services, it is now possible for the Union Government to levy Central-GST at a uniform rate so as to avoid multiple taxation and cascading. Effectively, the union government has now acquired the powers to levy tax on the retail value of goods manufactured. Once, comprehensive goods and services tax is in place it would not be necessary to provide for any abatement for value addition in the distribution chain. Consequent to the expansion of the base it should be possible to reduce the standard rate under union excise duties.

The Constitution (Eighty-eighth Amendment) Act 2003 may resolve the problem of the central government. However, empowering the states to collect and appropriate tax on selective services would not enable them to integrate the tax on services that might be collected by them under the present sales tax or VAT when it comes about. First, a tax paid under a central law even when collected by a state cannot possibly be rebated against a state level tax on consumption like the VAT. Second, there will also be the question of allowing credit for taxes paid on services in a state against the service taxes which will be realised by the centre. Therefore, assignment of taxing powers to the states in respect of services would have to be full and comprehensive.

In view of the foregoing, we recommend that the central government and state governments should come to an agreement in respect of a comprehensive tax on goods and services comprising, inter alia, of the following elements:

1. Both centre and states should exercise concurrent but independent jurisdiction over common or almost common tax bases comprehensively extending over all goods and services and in both cases going up to the final consumer.

2. Both centre and states will replace their existing octroi duties, central sales tax, state level sales taxes, entry tax, all stamp duties, telecoms license fees based on revenue sharing, turnover taxes, tax on consumption and sale of electricity, taxes on transportation of goods and passengers, excise taxes, and all other cascading-type central and state-level levies by two separate legislations for comprehensive consumption tax on all goods and services: Indian Goods and Services Tax Act and State Goods and Services Tax Act.

3. Both tax jurisdictions will exclude the taxes paid to the other jurisdiction from the assessment of value bases.

4. Both centre and states should have independent powers to fix tax rates. However, there has to be coordination between the two levels of government. If one level of government taxes the base excessively, it will adversely affect the base not only for itself but also for the other jurisdiction. The number of tax rates should be restricted to three *ad valorem* rates in addition to the zero rate. These three rates would be a floor rate, standard rate and higher rate.

Table 5.5 GST rates: international experience

Country	Standard rate	Country	Standard rate	Country	Standard rate
Austria	20	Greece	18	Norway	24
Belgium	21	Iceland	24.5	Portugal	19
Denmark	25	Ireland	21	Spain	16
Finland	22	Italy	20	Sweden	25
France	19.6	Luxembourg	15	Switzerland	7.5
Germany	16	Netherlands	19	United Kingdom	17.5
Australia	10	Bolivia	14.94	Chile	19
China	17	Iceland	24.5	Indonesia	10
Jordan	13	Mexico	15	Philippines	10
Botswana	10	Lesotho	10	Namibia	8
South Africa	14	South Korea	10	Taiwan (Chinese Taipei)	5

In the light of the rates of tax on goods and services across countries (Table 5.5) the standard rates of Central-GST and state-GST should not exceed 12 per cent and 8 per cent, respectively. Similarly, the floor rate of Central-GST and state-GST should be 6 per cent and 4 per cent, respectively. The higher rate under Central-GST and state-GST should be 20 per cent and 14 per cent respectively. Consequently, the maximum cumulative burden in the case of goods subjected to the standard rate would be 20 percent and in line with international best practice.

5. The design of the consumption-type goods and services tax, at both levels of the government, will be along the lines of a modern value added tax with the following typical features:

   (a) The computation of the GST liability should be based on the invoice credit method i.e., allow credit for tax paid on any intermediate goods or services on the basis of invoice issued by the supplier.

   (b) It should be structured on the destination principle.

   (c) The number of tax rates should be restricted to three ad valorem rates in addition to the zero rate as recommended above. The lower rate will apply to necessities like processed food and matches and the higher rate will apply to items like automobiles, air-conditioners, aerated water and polyester fibre yarn.

   (d) All international exports and sales outside the tax jurisdiction should be zero rated.

   (e) The centre and the states must draw up a common exemption list which may comprise of the goods and services listed at serial number 7 of the recommendations on integration of union excise duties and service tax in sub-section (c) above.

   (f) In the context of administrative and compliance cost, small dealers (including service providers) and manufacturers whose annual turnover does not exceed Rs. 25 lakh should be exempted from the state-GST, along the same lines as recommended in the case of Central-GST.

   (g) As in the case of Central-GST, a compounded levy at the rate of 2 per cent towards state-GST, could be levied on small dealers with annual turnover up-to Rs. 40 lakh. However, no input credit will be allowed against the compounded levy or purchases made from exempt dealers.

   (h) Unlike in the case of Central-GST, small scale industries should not be entitled to any separate higher threshold limit or concessional treatment under state-GST.

   (i) The taxpayers under state-GST will obtain both PAN and TAN from the income tax department to be used as a registration number under State-GST.

(j) The State-GST laws will reflect similar legal structures for penalties prosecution and preventive arrest/detention as contained in the Central-GST.

(k) The state-GST administration should design their collection and taxpayer information system along the lines recommended for Central-GST. For this purpose, they could consider riding on the IT infrastructure in the nature of OLTAS and TIN established by the income tax department. Where it is decided to establish independent IT infrastructure for such purposes, it should be ensured that the IT infrastructure of state GST administration and Central-GST administration are compatible and able to communicate with each other to facilitate taxpayer compliance and enforcement.

6. The states should be required to:

   (a) Allow the central government to levy tax on land and building, consumption or sale of electricity, goods and passenger carried by road, inland or waterways and luxuries including entertainments, amusements, betting and gambling, in exchange for the rights to levy tax on all services.

   (b) Abolish all forms of taxes on the entry of goods into a local area for consumption, use or sale therein.

   (c) Abolish stamp duty on lands and buildings. However, they will be allowed to levy VAT on immovable property along the lines indicated in this Report, and the muncipalities will continue to levy property tax.

   (d) Since the tax base relating to the tax on land and building, consumption or sale of electricity, goods and passenger carried by road, inland or waterways and luxuries including entertainments, amusements, betting and gambling would be subsumed in the State-GST, these small taxes will all be abolished.

7. The central government will collect GST on imports in two parts: one reflecting the Central-GST and the other reflecting the state-GST. The revenues from the later will be fully assigned to the destination state.

8. Both centre and states must draw up a common list in respect of commodities with negative externalities whose consumption need to be checked.

9. Both will continue to have the right to levy GST on petroleum crude and products, and natural gas. However, there will be no provision for allowing input credit for GST paid on these products. Effectively, such a levy would amount to an excise.

10. The right to tax tobacco will continue to remain with the centre and that of alcohol with the states. However, these "sin" taxes will be in the nature of excises as in the case of petroleum products recommended above.

This grand bargain with the States will give them increased fiscal space, give a boost to productivity and efficiency in the country through removal of inefficient taxes, and reduce compliance costs and tax evasion in the country through greater coordination of the Central-GST and the State GST.

5.4 Customs duty

Customs duty is levied on import of goods into India. The levy and the rate of customs duty are as per the Customs Act, 1962 (the Customs Act), and the Customs Tariff Act, 1975 (the Tariff Act), respectively. It comprises of the following:

1. Basic customs duty
2. Additional customs duty (CVD)
3. Special Additional Customs Duty(SAD)

Any or all of the above duty could be reduced /exempted for specified commodities /class of importers by the Central Government.

The rate of basic customs duty are specified under the Tariff Act for each item and vary according to the description of the said goods. Additional duty is equivalent to the central excise duty that would have been payable if the goods were manufactured in India. Special Additional Customs duty is equivalent to the central sales tax that would have been payable if the goods were sold by one person to another across states.[18]

The primary basis for valuation of goods under the Indian customs law is the transaction value. The transaction value of the goods is the price actually paid or payable by the buyer to the seller. Where the importer and seller are related to each other, the importer should prove that the relationship has not influenced the price. In such cases, the transfer price is open to scrutiny by the customs authorities and for determination of an appropriate value, the principle laid down in the GATT valuation agreement are generally followed. For the purpose of valuation of goods, any additional costs and services, the value of which is not included in the transaction value, are also added. Example of such costs and services are royalties, license fees or any other amount paid by the buyer as a condition for sale of goods.

Drawback of duties paid on imported goods which are re-exported as such or which are used in the manufacture of goods mean for export are also available.

During the 1990s, significant improvements have been made in the structure of customs tariff. The number of customs tariff rates has reduced significantly: from as many as 22 major basic duty rates in 1990-91 to 4 rates in 2003-04 (Table 5.6). The peak rate for non-agricultural goods (except motor vehicles and seconds and defectives of iron and steel) is 20 per cent as of 1st June, 2004. The other major slabs of customs duty rates below peak rate are 5 per cent, 10 per cent and 15 per cent. Most agricultural products have duty rates higher than 20 per cent, new motor vehicles attract duty at 60 per cent (second hand cars at 105 per cent) and seconds and defectives of iron and steel attract duty at 40 per cent. The structure has been rationalised in that input tariff rates have been made significantly lower than output tariff rates; and the rates themselves have been markedly lowered, so that the weighted average tariff rate has reduced from 55 per cent at the beginning, to around 20 per cent by the end of the fiscal year 2003-04 These changes in the structure of customs tariffs that resulted in reducing the number of customs classifications, have in turn lead to greater transparency and made customs administration much simpler. Recent surveys have shown significant decline in the dwell time of imports even though they continue to be substantially higher than the international standards.

While the rate structure was throughly reformed (and further reductions to East Asia-levels are contemplated), the customs tariffs remain burdened with exemptions with such a a wide coverage that they take a toll of the efficacy of administration. To give one example, in any standard publication of the Customs Tariffs Structure (containing over 1000 pages), there are over 400 pages describing about 120 general exemptions, some of which are further alphabetised and/or divided into lists. Further, each of the 99 chapters of the Custom Classification(CCCN), includes exemptions notifications. This is fur-

[18] SAD was being levied at the rate of 4 percent and has been abolished since 9th January, 2004.

Table 5.6 Evolution of customs duty structure

Year	No. of Major Basic Duty Rates (*ad valorem*)	Peak Basic Rate (*ad valorem*)	Basic Surcharge (Sp. Cus. Duty)	SAD
1990-91	22	More than 300	-	-
1991-92	20	150	-	-
1992-93	16	110	-	-
1993-94	16	85	-	-
1994-95	12	65	-	-
1995-96	9	50	-	-
1996-97	8	50	2% SCD	-
1997-98	7	40	5% SCD	-
1998-99	7	40	5% SCD	4
1999-00	5	40	10%surcharge	4
2000-01	4	35	10% Surcharge	4
2001-02	4	35	-	4
2002-03	4	30	-	4
2003-04	5	25	-	4
2004-05	4	20	-	-

ther compounded by separate exemptions notifications under the additional duty, special duty, and special additional duty. The complexity in interpreting the exemptions may only be imagined, adding to the discretionary power of lower-level tax administrators. In addition, the economic distortions created can be expected to easily override the seeming simplification in the nominal tariff structure achieved over the last decade. Recent fiscal budgets have failed to make improvements on this account. It is worthwhile noting that, in order to eliminate such problems, Chile has introduced a single tariff and eliminated exemptions. In sum, while bringing down customs tariff rates to comparable East Asian levels remains a challenge, a greater challenge remains in terms of streamlining the exemptions from the CCCN code. Until this is achieved, customs tariff reform remains quite incomplete. Only the abolition or a major scaling back of exemptions that would almost completely remove discretion, except where absolutely justified, would help restore transparency and honest administration.

5.4.1 Rate structure

The four major rates of duty are applicable to most commodities and account for about 90 per cent of the revenues from customs duty. However, there are multiple rates applicable to a handful of commodities, including agriculture. Such large number of rates lead to complexities of clearance procedures, resulting in disputes. It is therefore necessary to converge the rates of duties on these handful commodities (other then agriculture) to the major rates of duties. Since, the potential for disputes and abuse of discretionary powers exists even under four major rates of duties, it is therefore necessary, to design a duty structure within a narrow band.

Allocation of resources between sectors is determined by the relative prices of final goods manufactured by them. A tax on imports has the effect of increasing the domestic price of imports relative to exports. This encourages diversion of resources to import-substituting industries from export-

Table 5.7 Tariffs and effective protection on crude oil and products

(Per cent)

	Country	Duty on Crude	Duty on products	Effective rate of protection
1	Australia	0	0	0
2	Canada	0	0	0
3	USA	0	0	0
4	Singapore	0	0	0
5	New Zealand	0	0	0
6	Brunei Darussalam	0	0	0
7	Papua New Guinea	0	0	0
8	Mexico	10	10	10
9	Chile	11	11	11
10	Indonesia	0	0 / 5	0 - 50
11	Malaysia	0	0 / 5	0 - 50
12	South Korea	5	7 / 8	25 - 35
13	India	10	20	60–70 per cent

This assumes 10 per cent value addition. In India's case, there are a number of products where the duties are lower than 20 per cent.

oriented industries. Effectively, therefore, a tax on imports is a tax on exports. In order to neutralise this bias, countries try to establish a paraphernalia for duty drawback for exports. This approach yields high transactions costs in interfacing with a government agency for obtaining refunds. It also gives rise to fraud and revenue leakage.

It is not possible to design a duty drawback program which accurately compensates for import taxes: it invariably results in either under-compensation or over-compensation. Where there is under-compensation, the bias against export-oriented industries continues thereby adversely affecting exports. Where there is over-compensation, it effectively reduces to a subsidy to exporting companies.

Further, duty drawback schemes are inefficient in as much as they increase transaction costs, result in leakage of revenues due to fraudulent claims and breed corruption. The Task Force believes that the simplest solution is to have a liberal trade regime in the first place, by reducing tariffs to a minimum. The regime advocated in this report is one where exporters interface with an IT system for obtaining a refund for the GST embedded in their exports.

One major source of customs duty revenues is import of crude oil and petroleum products. At present, import of crude oil is liable to customs duty at the rate of 10 per cent, while duties on petroleum products are at rates as high as 20 per cent. Given value addition of about 10 per cent by the oil refineries, these rates of duties on input (crude oil) and output (petroleum products) provide 60-70 per cent effective rate of protection to domestic refineries.

This is far too excessive by international standards, as would be evident from Table 5.7. The effective rate of protection in the sample countries is the highest in Indonesia and Malaysia (50 per cent). In South Korea the effective rate of protection is in the range of 25 to 35 per cent. In most other cases the effective rate of protection is less then 10 per cent, or zero. Therefore, with the dismantling of the administered price mechanism, there is a strong case for aligning the effective rate of protection for petroleum refineries in India with those prevailing in similar countries like Indonesia, Malaysia and South Korea. This implies that the duty differential between crude and petroleum products should not exceed 5 percent.

It should be apparent that even if the level of the rates of duty are low, apparently a small difference in the rate applicable to inputs and final products have very large economic efficiency implications.

5.4.2 Tariff exemptions

Whereas the customs tariff indicates the peak rate of duty, also called the tariff rate of duty applicable on a particular item, it is not the case that this is the duty actually leviable when the said item is imported. The leviable duty also called the effective duty is determined in the context of th duty exemption notifications, if any, issued in respect of the said item in terms of Section 25 of the Customs Act, 1962. Thus, on account of an exemption an imported item may be subjected to a duty lower than that prescribed in the tariff. At times, the duty payable may even be nil. The exemptions are mainly of three types as follows:

1. General exemptions which are non-conditional and can be availed by all importers.
2. General exemptions which are subjected to conditions such as end-use.
3. Ad-hoc exemption, which are issued in respect of specific imports for security, strategic or charitable purpose - the number of ad-hoc duty exemptions are coming down, no doubt, due to the effect of the legislative change, in 1999, restricting the scope of the exemptions to imports of strategic, secret interest or for charitable purposes.

At present, the said exemptions can broadly be placed into the following categories:

1. Importer specific - e.g., Government (defense and police) etc.
2. Project and purpose specific - e.g., training, educational, research, oil exploration etc.
3. Social and health sector/objective specific - e.g., handicapped persons, charitable and social welfare organisations, donations and gifts, medicines, drugs and hospital equipment etc.
4. Export related - e.g., samples, packaging materials, durable containers, advance license, passbook etc.
5. Sport related - e.g., sports goods, prizes, medals and trophies.
6. International commitments - There are a number of international agreements that bind customs duties. These include the GATT/WTO bound rates, contractual commitments such as oil exploration contracts, Information Technology Agreements, exemptions to privileged persons, organisations, authorities and foreigners, preferential areas etc.

A duty exemption naturally has revenue implication. On their part conditional exemptions also invariably necessitate imposition of regime of certification, verification, discretion, etc., which adversely impact the clearance of goods, result in higher administrative costs, use of discretionary powers, and raise compliance issues on account of misuse. Exemptions are also nothing but a subsidy, and in fact, a discretionary subsidy. Thus, aside from the obvious impact on the tax to GEP ratio, the duty exemptions have undesirable side effects. The fact that exemptions also cause loss of transparency is another aspect of serious concern for the policy makers.

5.4.3 Recommendations

In view of the foregoing, we recommend:

1. Basic customs duty should be sharply reduced to a three rate structure of 5 percent, 8 percent and 10 percent. The rates of duty applicable to most commodities must fall within this 5 to 10 per cent range. The 5 per cent rate should be applicable to basic raw materials like coal, ores, and concentrates, xylenes etc. The 8 per cent rate should be applicable to intermediates goods which will be used for future manufacture (capital goods, basic chemicals, metals etc.). The 10 per cent rate should be applicable to finished goods other than consumer durables. However, consumer durables may be taxed at a higher rate of 20 per cent, motor vehicles at 50 per cent, and specified agricultural products and demerit goods at 150 per cent.

2. These tariff changes should coincide with the comprehensive reform of the structure of CVD outlined below.

3. The rates of duty on crude oil and petroleum products should be reduced to 5 per cent and 10 per cent respectively.

4. All exemption must be eliminated except those relating to:

   (a) Life-saving goods.

   (b) Goods of security and strategic interest.

   (c) Goods for relief and charitable purposes.

   (d) International obligations including contracts.

5. The DEPB scheme should be merged with the duty-drawback scheme.

These recommendations relating to customs duty will rationalize the tariff structure in conformity with the best international practice.

5.5 Personal income tax

In 1947, when the country gained independence, the Indian economy was characterised by low growth rates, low savings and investment rates, a virtual non-existent industrial sector, low risk bearing ability of the private sector, high rates of inflation and a high level of inequality in distribution of income. Therefore, the economic policy was focused on building a vibrant public sector as an engine for economic growth. Consequently, government resorted to increasing level of taxation and public borrowing as a means to raise resources for increased public spending. Simultaneously, the government was also concerned about reducing the income disparities. Given the low income and consumption base on account of extremely low levels of per-capita income, there was very little scope for horizontal expansion of the tax base. Therefore, resource-raising exercise essentially became an exercise in increasing rates of taxation on both income and consumption thereby, impairing economic efficiency. In order to minimize the distortionary effects of high rates of income tax, particularly on private investment, numerous investment-based incentives were introduced in the tax system. High rates of income tax exacerbated the inherent bias against savings. Therefore, there was a proliferation of ill though out incentives for savings, which was necessary to finance both public and private investment. Therefore, high rates of taxes and exemptions/ incentives were feeding on each other. Consequently, the income tax law became highly complex, both for compliance and administration.

By the beginning of the 1980s, things had begun to change - starting with developed countries and then spreading to globalising developing nations. By the mid-1990s, the structure, design and enforcement of both individual and corporate income tax underwent major changes. Earlier ideological objectives were substituted by considerations of incentive compatibility, reasonableness, administrative feasibility, stability and the credibility of fair enforcement.

The first step in reforming the income tax structure was reducing the number of as well as the level of rates. By the mid 1990s, many developing countries had emerged from the reform process having legislated individual income tax structures with significantly lower and fewer rates - typically 15-25-30 per cent. Even India legislated comparable rates in 1997. similarly the corporate income tax rates were slashed - sometimes halved from the prevailing rate - driven by the twin objectives of administrative feasibility and better tax compliance. However, one negative ramification of the early high marginal tax rates that has been difficult to remove from the income tax structure is the continuing high incidence of exemptions, allowances, erroneously perceived as instruments to achieve particular social or development goals. In addition, it systemically encourages tax payers to toy with the interpretation of the tax law, complex as it has become. In the case of the individual income tax, the incentives that erode and complicate the tax base the most relate to savings.

The results of the income tax laws comprising of complex, allowance and exemption, are two-fold. For honest taxpayers, on the one hand, filing the income tax return continues to be an annual exercise in complexity, and an uncomfortable fear of the assessment by the tax administrator that is to follow. On the other, a direct result of the complexity in the tax structure is the difficulty faced by tax administrators in carrying out initial assessments (processing), as well as to execute selective audit functions.

The global experience with lower tax rates and fewer opaque exemptions, is that the administration of income tax became much simpler. The administration's resources was better spent on alternative investments - such as modernising the tax administration through widespread computerisation, including electronic filing, better data processing and mining, and production of far better statistical output. These resources and inputs, in turn, were most usefully employed both in formulating future tax policy, as well as in better enforcement, through more transparent and finer tax audit selection. It is now widely accepted that the design of tax policy is of paramount importance for tax administration. If the objective is to have a transparent, efficient and feasible tax administration, then the structure of all taxes should comprise common elements. These are low rates, few nominal rates, a broad base, few exemptions, few incentives, few surcharges, few temporary measures. And in the rare instances where there are exceptions, there should be clear guidelines.

A taxpayers decision to disclose or conceal his income will depend on the relative strength of cost and benefit of increasing concealment or noncompliance. The marginal benefit from noncompliance is equal to the marginal tax rate while the marginal cost is determined by the probability of detection and being penalised. In turn, the later is determined by the ability of the government to unambiguously specify the tax base, amount of information available to the tax administration about transactions which help to assess the tax base and the ability of the government to enforce an identified tax liability.

Conceptually, defining the tax base of income tax is contentious and therefore difficult. This is further compounded by the plethora of exemptions and incentives mostly with ambiguous eligibility criteria and conditions. As a result, even where the tax administration has sufficient information, its ability to enforce is considerably diluted in view of the ambiguous definition of the tax base. Therefore, defining the tax base as clearly as possible is of para-mount importance: as a first step the plethora of exemptions and incentives should be limited and rationalised, if not eliminated.

On the subject of personal income tax rates, it is well recognised that the rates of tax affect economic[19] and compliance behaviour of taxpayers i.e., choice between work and leisure, the choice between consumption and savings, and also the compliance behaviour of taxpayers. The design of a personal income tax rate schedule must therefore be equitable and efficient - which are potentially conflicting objectives. A highly progressive tax schedule, while meeting the ends of vertical equity, causes higher distortion in the economic behaviour of taxpayers and therefore promotes inefficiency. Further, high rates of taxes induce tax evasion, thereby undermining the effective impact on equity. Therefore, it is now well accepted that-

1. The basic exemption limit must be at a moderate level- an appropriate balance between the tax liability at the lowest levels, administrative cost of collection and compliance burden of the smallest taxpayers. The ability of the tax administration to render quality services to taxpayers will also significantly affect the choice of the exemption limit.

2. The number of tax slabs should be few and their ranges fairly large to minimize distortion arising out of bracket creep.

3. The maximum marginal rate of tax should be moderate, so that the distortions in the economic behaviour of taxpayers and incentive to evade tax payment are minimised.

The evolution of the personal income tax rate structure is shown in Table 5.8. In 1949-50, the tax schedule was amenable to voluntary compliance; basic exemption limit was at a moderate level of Rs.1,500 at current prices, there were only four tax slabs with marginal rates ranging from 4.69 per cent to 25 per cent for taxable income above Rs.25,000.[20] As the need for public expenditure increased during the 1950s and 1960s, the rates of taxes began to sharply increase to reach a peak rate of 97.75 per cent in 1973-74 but the exemption limit steadily increased to Rs.5,000 and the number of slabs also increased to eleven. Clearly taxation at such ”extortionary” rates was not conducive to compliance. Since then, there has been a progressive improvement in the structure of the tax schedule.

The present tax schedule (Table 5.9) has been in place since 1997-98.[21] Since we do not have the mechanism for inflation indexation on an annual basis, it is necessary to undertake a comprehensive review of the tax schedule at least after six years.

5.5.1 Exemption limit

Ordinarily, taxpayers below a certain income level are exempted from payment of tax primarily because the social cost of effecting such a transfer out ways the social benefit

[19] Choice between consumption and savings and choice between work and leisure.

[20] However, there was a super profit tax for incomes above Rs.30,000 at current prices.

[21] Since then the only change has been the increase in the exemption limit from Rs.40000 to Rs.50000 in 1998-99.

Table 5.8 Evolution of income tax rate structure

Year	Exemption limit	Number of Rates	Entry rate	Peak rate	Income at which peak rate applies
1949-50	1500	4	4.69	25	15000
1955-56	2000	5	4.93	26.25	15000
1960-61	3000	7	3.15	26.25	20000
1970-71	5000	11	11	93.5	200000
1971-72	5000	11	11	93.5	200000
1972-73	5000	11	11	93.5	200000
1973-74	5000	11	11	93.5	200000
1974-75	6000	8	13.2	77	70000
1980-81	8000	8	15	66	100000
1985-86	18000	4	25	50	100000
1990-91	22000	4	20	56	100000
1991-92	22000	4	20	56	100000
1995-96	40000	3	20	40	120000
1997-98	40000	3	10	30	150000
1998-99	50000	3	10	30	150000
1999-00	50000	3	10	33	150000
2000-01	50000	3	10	35.1	150000
2001-02	50000	3	10	30.6	150000
2002-03	50000	3	10	31.5	150000
2003-04	50000	3	10	30	150000
Proposed	100000	2	20	30	400000

Table 5.9 Present income tax structure

Income level	Tax rates
Below Rs.50,000	Nil
Rs.50,001 to Rs.60,000	10 per cent of the income in excess of Rs.50,000
Rs.60,001 to Rs.1,50,000	Rs.1000 plus 20 per cent of the income in excess of Rs.60,000.
Above Rs.1,50,000	Rs.19,000 plus 30 per cent of the income in excess of Rs.1,50,000

from it. Further, in most developed countries, the exemption limit is annually adjusted for inflation. The present personal income tax exemption limit of Rs. 50000 was fixed in 1998-99. The reasonableness of the present exemption limit has to be considered with reference to a bench mark point in time.

An analysis of the performance of personal income tax over the last 55 years shows that the highest recorded personal income tax - non-agricultural GDP ratio was 2.97 per cent1 achieved in 1950-51.[22] Therefore, it could be useful to use the tax rate structure applicable in 1950-51 as a bench mark and to adjust the different tax slabs for inflation. The tax rate structure applicable in 1950-51 along with inflation adjusted equivalent tax slabs is presented in Table 7 The exemption limit in 1950-51 was Rs.1500 equivalent to [23]about Rs. 46500 in 2004-05. This

[22]The PIT-NAGDP ratio in 2003-04 is as low as 1.84 per cent.

[23]The inflation adjustment is based on time series data for consumer price index for industrial workers

Table 5.10 Income tax rates of 1950-51

Slab	Cutoff in 2004-05 rupees	Basic rate	SC
First 1,500	46,472	0	0
1,500-5,000	154,908	4.69	5
5,000 - 10,000	3,09,816	10.94	5
10,000 - 15,000	4,64,724	18.75	5
Above 15,000	4,64,724	25	5

is lower then the present exemption limit. However, the marginal tax rate applicable to the first slab was 4.93 per cent only for taxable income up-to Rs.5000 (equivalent to an estimated Rs.154908 in 2004-05) and the average tax liability was still lower. At the present marginal rates of tax of 10 per cent to 20 per cent for incomes up-to Rs.154908, the **exemption limit has to be substantially higher** to be close to the average tax liability in 1950-51 at comparable levels.

Some experts while analysing personal income tax compliance behavior during the period 1965-66 to 1992-93, have identified the exemption limit of Rs.22000 in 1990-91 as one of the best practices. Adjusting this for inflation, the corresponding level in 2004-05 is estimated at Rs.59400. Similarly, if the exemption limit in 1998-99 were to be used as the base, the corresponding level in 2004-05 is estimated at Rs.62940.

An alternate way of determining the appropriate level of exemption limit is to use the net social benefit from collecting taxes from the marginal taxpayer. If the costs of administration and compliance were zero, the ideal exemption limit would also be zero. The need for an exemption limit arises from the willingness to forgo revenues in order to save on collection costs. Experts believe that the optimal exemption limit may actually be much higher then those existing. This is primarily

(1993-94=100).

Table 5.11 Growth of number of taxpayers, across increases in the exemption limit

Year	Exemption Limit	Number of Taxpayers (Lakh)
1980-81	12000	46.61
1981-82	15000	47.97
1984-85	15000	55.02
1985-86	18000	62.61
1989-90	18000	93.91
1990-91	22000	96.71
1991-92	22000	104.5
1992-93	28000	116.68
1993-94	30000	132.09
1994-95	35000	140.95
1995-96	40000	159.79
1997-98	40000	217.45
1998-99	50000	250.52

because of the very high compliance costs for small taxpayers. Therefore, there is a strong case for increasing exemption limit but there is equally compelling case for directing policy measures to simplifying compliance procedures.

The case against raising the exemption limit is built on several grounds. First, any increase in exemption limit will lead to decrease in the number of taxpayers. This is true only in a static condition. In a dynamic world, income of the taxpayers increase overtime and therefore the 'dropouts' will be pushed back into the tax-fold. The empirical evidence, shown in Table 5.11, suggests that episodes of increase in exemption limit have been followed by an increase in the number of taxpayers.

Further, the taxpayer base would remain protected because of the one-in-six scheme. The government could also consider using the gross total income as the basis for filing tax return rather than the taxable income i.e gross total income minus deductions for tax incentives under chapter VI-A. **Second**, Box 2: The economics of the threshold limit

Analytically, in order to determine the appropriate level of exemption limit, the social benefit from collecting taxes from the marginal taxpayer is compared against the the costs of administration and compliance. If these complicance costs were zero, the optimal exemption limit would also be zero. The need for an exemption limit arises from the willingness to forgo revenues in order to save on costs to society that flow from compliance and administration.

The rationale for raising revenue is the belief that resources are more valuable to society in the hands of the government than in those of taxpayers. Since taxation involves cost to the private sector towards compliance (additional to those of the resource transfer itself) and to the government towards administration- because it distorts economic activity - an additional Re 1 of revenue should only be raised if the uses to which it is put is valued by society at more then Re.1.

Suppose a government considers raising the threshold level of income, denoted E, by Re.1. For each taxpayer consequently taken out of the tax net, the government loses revenue equal to tE, where t denotes the tax rate applicable at the threshold level of income. This also saves administration costs of A per taxpayer. The net loss to the government is $tE - A$.

Similarly, each taxpayer taken out of tax, on the other hand, gains tE in tax savings and saves compliance cost of C. Therefore, the net gain to the taxpayer is $tE + C$. Suppose the social value of Re.1 in the hands of the government is d. The optimal threshold limit E^* thus works out to:

$$E^* = \frac{dA + C}{(d-1)t}$$

In order to obtain numerical values for the optimal threshold limit E^*, we need to put numerical values to the parameters of this formula. As an illustration, we assume an administrative cost A, of servicing the marginal taxpayer, is Rs.100. The cost of compliance C, as estimated by an NIPFP study for the Planning Commission, is placed at Rs.2500 for salaried and Rs.6700 for non-salaried. We place the social value of Rs.1 in the hands of the government d at 1.2. In this case, the optimal exemption limit for different entry point tax rates works out as follows:

	Entry Point Tax Rate		
Taxpayer type	10	15	20
Salaried	1,31,000	87,333	65,500
Non-salaried	3,41,000	2,27,333	1,70,500

The optimal exemption limit is therefore estimated to be much higher then those existing. This is primarily because of the very high compliance cost for small taxpayers. In this context, there is a strong case for increasing exemption limit, but there is an equally compelling case for directing policy measures to simplifying compliance procedures.

increase in exemption limit will result in loss of revenue. This may be true in an environment where there is full compliance. Where there is large-scale tax evasion, particularly among the self-employed, there is a well known tendency to disclose income marginally above the threshold limit and acquire the legitimacy of being a taxpayer at nominal cost. Effectively, there is no loss in revenues from such taxpayers. **Third**, the exemption limit relative to per capita income is substantially higher than those prevailing in other countries. Unlike in the developed countries, a relatively higher proportion of revenues in India is collected from indirect taxes. Since the indirect taxes are also levied on items of mass consumption, individuals with low per capita income also end up bearing the burden of taxes disproportionate to their ability to pay. Any additional burden through direct taxes would be excessive. For comparison, it is necessary to evaluate the total tax burden at different income levels across countries rather than the burden of direct taxes only. Such comparison will suggest an upward revision of the basic exemption limit.

An important aspect that needs to be borne in mind in determining the level of the exemption limit is the fact that adjustment of the exemption limit for inflation is with a lag. Therefore, it is important to peg the exemption limit a little higher then the actual erosion in its real value.

5.5.2 Tax rates: single rate or multiple rates

At present, there are three tax slabs. Most countries have three to five slabs. As mentioned, greater the number of tax slabs, larger is the distortion due to bracket creep. A moderately progressive flat, or single marginal rate, income tax levied on a comprehensive base is the simplest and fairest. With a flat rate income tax, most of the defects in, and the problems caused by, an income tax with a progressive rate schedule virtually disappears. With a moderate single rate, almost all the deductions and tax-preferences could be eliminated, all those with taxable incomes can opt for tax deduction at source to the maximum extent possible, full integration of personal and corporate income taxes can be achieved by applying the same single rate to both incomes and exempting dividends in the hands of the shareholders, fluctuations in income over time can be easily dealt, all capital gains can be taxed as ordinary income, and there will be no bracket creep.

However, the single most significant demerit of the system is that a single rate cannot be pitched at a high level and therefore, the rate of progression that can be achieved will inevitably be moderate. In the Indian context, since a single rate would have to be around 30 per cent, the exemption level would also have to be fairly high. That, in turn, would leave out some people who could reasonably be brought within the income tax net with a lower tax rate. Therefore, a single rate system may not be feasible at the present stage of evolution of the tax system in India. The alternative lies in a multiple rate schedule, but with very little spread.

One of the many options is to start with a relatively low entry tax rate in personal income tax so that it does not frighten potential taxpayers from being in the tax net. The potential taxpayers at the lower end of the scale are frightened not by the entry rate of tax (since the average tax continues to be very low) but more by the compliance and enforcement procedures. However, with a low entry rate, the number of rates inevitably multiplies, and the tax administration ends up at square one - all the problems associated with a progressive rate schedule. Therefore, it is preferable to have a two rate schedule for personal income tax, which is next best to a single rate.

5.5.3 Tax slabs: broad-basing

As stated above, rates of personal income tax were at their peak in 1973-74. They have steadily declined, since then. In 1973-74, the tax rates of 10 per cent and 20 per cent were applicable for incomes up to Rs.10,000 and Rs.20,000 respectively. The corresponding inflation adjusted income levels are estimated to be Rs.1,02,175 and Rs.2,04,350 in 2004-05. Thus, the existing corresponding income levels of Rs.60,000 and Rs.1,50,000 are substantially lower than the inflation-indexed levels - thereby resulting in an increase in the real tax liability.[24]

Historically, while the top marginal rates of tax have been reduced, the tax liability at the middle has indeed increased. This has, not surprisingly though, given rise to the problem of "the missing middle". If the full effect of lower tax rates has to be realised, it is not only necessary to have an optimal enforcement strategy but also ensure that the benefits of a tax cut apply to all class of taxpayers - rather than be restricted to a handful of taxpayers at the top end. This is possibly achieved by broad basing the tax slabs.

In view of the above, the Task Force considered two alternative personal income tax rate schedules, shown in Table 5.12. Given the high estimates of compliance cost, and the empirical evidence on the positive impact of buoyancy after the liberalisation of the personal income tax rate schedule in 1997 and 1998, the Task Force would recommend the adoption of Alternative II.

[24]The Task Force would like to acknowledge the intellectual contribution of Surjit Bhalla, and the use of his paper *Tax rates, tax compliance and tax revenues: India, 1988-2004* in thinking about issues on personal income tax reform. This paper can be accessed at http://www.oxusresearch.com on the world wide web.

Table 5.12 Proposed personal income tax structure

Income level	Tax rates
Alternative I	
Below Rs.65,000	0
65,001 to 4,00,000	20 per cent of the income in excess of Rs.65,000
Above 4,00,000	Rs.67,000 plus 30 per cent of the income in excess of Rs.4,00,000
Alternative II	
Below Rs.100,000	0
100,001 to 4,00,000	20 per cent of the income in excess of Rs.100,000
Above 4,00,000	Rs.60,000 plus 30 per cent of the income in excess of Rs.4,00,000

The Task Force is conscious that there are limits to the extent to which voluntary compliance can improve in a given year. The revenue loss from the adoption of Alternative II may not be fully matched by gains in compliance in the very first year.

Therefore, this should be simultaneously accompanied by the elimination of standard deduction for salaried employees, in order to address revenue considerations. This will augment tax revenues by an estimated Rs.4,000 crore. The elimination of the standard deduction is particularly important, given that the 'conveyence allowance' is exempt from income tax. The recommendation to eliminate standard deduction is also consistent with the best international practice, and with the policy proposals in the past by several committees which have worked on direct taxes.

5.5.4 Tax concession for savings

In most countries, it is mandatory for individuals to contribute/save for (i) old-age, invalidity, and survivors' benefits; (ii) benefits for sickness and maternity; (iii) occupational or work-related risks; (iv) unemployment protection; and (v) family assistance (hear after collectively referred to as ”social security”). State which provide social security schemes may not provide sufficiently for all such purposes. Such contributions are generally granted preferential treatment by the tax laws.

The case for tax support to savings for social security is built around several arguments. The first argument is that the state gives incentives to save for social security because in the absence of incentives, individuals will fail to make 'sufficient' provision. There are a number of reasons why, first this rationale may not be valid and, secondly, why the tax system is not a good way of achieving it. It is hard to define 'sufficiency' of income beyond an adequate minimum. Offering tax incentives, particularly for retirement savings, may not ensure that everyone achieves a minimum standard; some will still fail to provide whereas others may even over-provide. Other means of ensuring that retirement living standards approach the level during working life may be more effective and, perhaps, less distortionary.[25] The second argument is one of 'moral hazard' - individuals will not provide for themselves if they know the state will give them an adequate income anyway. Pensions are partly or wholly means-tested in a number of countries. This means-testing produces a substantial disincentive to save for retirement, especially for people with low incomes. Again, however, it does not follow that attaching fiscal privileges to pensions is an effective way of minimizing the cost to the state, compared, for example, with mandating a certain level of contributions. The reduction in current revenues that results from the tax incentive adds to this argument. The third argument is that tax incentives for pensions appear to increase pension savings.[26] Whether this results, however, from a substitution of pensions for other savings media or from an increase in overall savings is difficult to ascertain. Consider the case of a person who is a ”target saver”. His only goal is to have a given amount of consumption in the future - no more and no less. For such ”target saver”, saving and the after-tax interest rate move in opposite directions. If the exemptions for savings are eliminated, then the only way for him to reach his target is to increase savings, and vice versa. Tax incentives cost the government by reducing revenues, cutting public sector saving. Even if household savings increase, the overall effect on national saving is uncertain.[27] Given the inconclusive nature of this literature, it does not seem wise to suggest that a desire to increase economy-wide saving either is or should be a major objective for the taxation of pensions. The fourth argument support tax incentives as an inducement to change the composition of saving in favour of long-term retirement savings. The theory of tax incidence on financial instruments indicates

[25]For example, the state can adjust the level of compulsory private pension contributions (the 'second pillar').

[26]Examples include the 'success' of registered retirement savings plans, RRSPs, in Canada, personal pensions in the United Kingdom, and individual retirement accounts, IRAs, in the United States.

[27]The empirical evidence on the effect of tax incentives on savings is inconclusive. The OECD study of taxation and savings concludes its survey of evidence in a number of countries, by observing that 'there is no clear evidence that the level of taxation, along with other factors affecting the rate of return, does generally affect the level of savings'.

no reasons for differential treatment for those of long-term maturity from those of short and medium-term maturity, taking the view that the term structure of interest rates would ensure efficient allocation of savings. In particular, the demands of fiscal neutrality that imposition of tax should not distort the choice between (a) different forms of saving, and (b) between consumption and saving are ensured under a non-discriminating tax treatment of savings irrespective of the maturity period. Tax incentives, particularly in developing countries, benefit only individuals in the upper tail of the income distribution who have the resources and the financial information required to take advantage of the incentives. A large section of savers who are outside the tax net do not benefit from such incentives. Therefore, tax incentives raise serious distributional issues. The objective of promoting long-term savings as a useful policy tool to provide stability in investment and growth could be better achieved by the term structure of interest rate.

The most compelling case for providing tax incentive to savings (including long-term savings) arises from the fact that there is double taxation of savings under a comprehensive income tax: first at the point of contribution[28] and again when the benefits are received. Therefore, a comprehensive income tax is inherently biased against savings. Tax incentives for savings are necessary to neutralize this bias and eliminate the distortions in the choice of consumption / savings.

In the context of any long-term saving scheme, particularly the pension system, it is not sufficient to provide tax incentives. What is particularly important is to have an appropriate and stable tax regime for such pension systems because of the long time scale that is generally involved in building up an adequate pension fund.[29] Fifty years may elapse between the time when a pension scheme member pays his first contribution and the time when he draws his last benefit from the pension fund. If tax laws are changed during this period, it can be complicated and costly to protect the legitimate expectations of those who have been making provisions on the basis of the old law. There is always a problem of time inconsistency. In the absence of a promissory estoppel against the statute, any government in the future may not feel bound by promises of the previous government for tax exemption or concessional tax treatment ofpensions in payment or investment returns and may view pension funds as soft revenue targets. This would be particularly so in the context of pressures to reduce fiscal deficit.

Further, the fact that the present system of taxing pensions and saving are economically inefficient and inequitable, it is reasonable to expect changes in tax rules as tax reform progresses. Therefore, it would be futuristic to restrict the tax ”incentives” for pensions to only maintaining fiscal neutrality between consumption and savings rather than distort household portfolio.[30] Logically therefore tax incentives for all other forms of savings must essentially follow the same pattern so that the yield curve based on post tax return is not biased against long-term pension savings.

Generally, there are two distinct types of tax

[28] Under a comprehensive income tax contributions to savings plans are out of post taxed income.

[29] This is more so important in the case of a fully funded pension system.

[30] Individuals will always discount the tax incentives in anticipation of future changes in tax laws.

system: a comprehensive income tax and an expenditure tax. Under a comprehensive income tax all sources of income is explicitly taxed.[31] An expenditure tax, on the other hand, only taxes consumption. Effectively it exempts from tax the returns from savings until they are consumed.

There are two main forms of expenditure tax. The first involves giving tax relief on income that is saved, exempting from tax any interest and gains accumulating on those savings, but then taxing the total proceeds as and when the savings are withdrawn for consumption. This form is often described as EET, with E denoting an exemption or relief from tax and T denoting a point at which tax is payable.

Another form of expenditure tax regime followed is one where no relief is given for the investment, but the accumulating interest and gains and the proceeds of the investment are exempt from tax. This system is often described as TEE. The EET system is the classical example of an expenditure tax. The TEE system is often called the ‘pre-paid expenditure tax’.

In a flat rate tax system, EET produces an equivalent outcome to TEE. They both confer a post-tax rate of return to saving equal to the pre-tax rate of return. They are neutral between consumption now and consumption in the future. This also means these regimes are equitable in their treatment of different individuals: people who save for future consumption pay the same tax as those who consume now. Finally, the two systems also deliver the same net present value of revenues to the government. However, the timing is different: revenues are deferred until retirement under EET, but received immediately under TEE.

In practice, the EET and TEE systems may not have the same effect because of the point at which the tax exemption occurs. If an individual pays a different marginal income tax rate while in work from the tax rate paid in retirement, then pre- and post-tax rates of return will no longer be equalised. The individual will benefit more from a regime granting tax relief when his or her marginal rate is higher. In a progressive tax system, however, different forms of expenditure tax are not equivalent.

Under a comprehensive income tax system all income is taxed when it is received so saving is from taxed income; interest income from savings is taxed; but proceeds of saving do not suffer further tax. In practice, this system is described as TTE. Another variant of the comprehensive income tax is one where the tax exemption occurs at the point of contribution, while fund income and benefits are taxable (ETT). The effects of these two systems are the same. These two systems result in a disincentive to saving, because consumption now is worth more than consumption in the future. In as much as savings are taxed twice, this system is inherently biased against savings.

These two benchmark tax systems are different ways of interpreting ’fiscal neutrality’ with respect to savings. Equalizing pre- and post-tax rates of return is neutral between present and future consumption. A comprehensive income tax is neutral between consumption and saving, treating savings in exactly the same way as any other form of consumption. However, savings are not a commodity like any other good or service. They

[31] In its most comprehensive form it will also tax sources of imputed income, such as imputed rental income from owner-occupied houses and accrued but unrealised capital gains.

are a means to future consumption, and this is particularly obvious where saving for retirement is concerned. Neutrality between consumption now and consumption in retirement is the relevant concept for taxing pensions, and that is the form of neutrality achieved by the expenditure tax.

The arguments as to whether income or expenditure should be used as a tax base have often been rehearsed. An expenditure tax treats two individuals the same, regardless of when they choose to consume the income, which they earn, whereas a comprehensive income tax gives rise to double taxation of savings. This is because a comprehensive income tax taxes income when it is earned and also taxes interest before the money is spent. In the case of pensions, therefore, it can be argued that an income tax system taxes post-retirement consumption more than pre-retirement consumption. However, the main economic point in the debate concerns the distortion of decisions to consume or save. An expenditure tax allows individuals to receive interest gross of tax. They can therefore determine their preferences for consumption now or in the future without distortions imposed by the tax system. By contrast, a comprehensive income tax (TTE) (where returns to saving are taxed) would create such distortions, with associated inefficiencies.

There is an alternative argument, however. When wages are saved they become another factor of production (capital). It can be argued that the returns to all factors of production should be taxed equally. A tax on expenditure alone is equivalent to a tax on wages alone with no tax on returns to capital. Hence a tax on labor distorts the work/leisure decision in the same way that a tax on capital distorts the save/consume decision. To tax returns to labor but exclude returns to capital, encourages those engaged in production to use less labor and more capital. It would seem reasonable, looking only at these economic arguments, to tax the return to all factors of production. This would suggest a comprehensive income tax base rather than an expenditure tax base. This is the most powerful argument against an EET basis for the taxation of pension funds. If tax revenues have to be raised, the issue, which needs to be resolved, is the trade-off between distortions caused by the consumption/savings decision and the work/leisure decision. In any developing economy, the trade-off must settle against the former, that is, minimize consumption/saving distortions.

In order to neutralize the bias against savings, most countries design their income tax structure, so as to provide for exemption/concessional tax treatment of the various savings instruments by following one of the two methods. Some experts are also of the view that the distortion arising out of the inherent bias against savings could be tolerated by adopting a simple income tax structure with reasonable rates and a comprehensive base.

The Indian tax system (emanating from the Income Tax Act, 1961) provides broadly the following types of tax incentives for financial savings:

1. Deduction under section 80CCC for contribution to pension funds of Life Insurance Corporation of India or any other insurer, subject to a ceiling of Rs.10,000/-. The pension/annuity under the scheme is, however, taxable.

2. Deductions, provided in Section 80L allow for exemption of income up to Rs.12,000/- from income tax on specified financial instruments (including bank deposits, NSC, post office

deposits, Government securities, etc. with an additional and exclusive sub-ceiling of Rs.3,000 for interest income arising from Government securities).

3. Exemption under Section 10(10D) in respect any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy [other than any sum received under sub-section (3) of section 80DDA] [or under a Keyman insurance policy]

4. Exemption under Section 10(11) and Section 10(12) in respect of any payment from a provident fund set up by the Central Government or set up under the Provident Fund Act 1925 or a recognised provident fund.

5. Unlimited exemption under Section 10(13) in respect of any payment from a Superannuation Fund.

6. Unlimited exemption under Section 10(15)(i) in respect of income by way of interest, premium on redemption or other payment on notified securities, bonds, annuity certificates, savings certificates, other certificates and deposits issued by the Central Government.

7. Unlimited exemption under Section 10(15)(iib) in respect of interest on notified Capital Investment Bonds. However, no bonds can be notified after first day of June 2002.

8. Unlimited exemption under Section 10(15)(iic) in respect of interest on Relief Bonds.

9. Unlimited exemption under Section 10(15)(iid) in respect of interest on notified Bonds. However, no bonds can be notified after first day of June 2002.

10. Unlimited exemption under Section 10(15)(iv)(h) in respect of interest on notified public sector bonds.

11. Unlimited exemption under Section 10(15)(iv)(i) in respect of interest on deposits out of moneys received by an employee on retirement.

12. Tax rebate, provided in Section 88, in respect of investment in specified assets (such as NSC, NSS, EPF and PPF, tax saving units of mutual funds, premium paid on life insurance, repayment of housing loans, and infrastructure bonds of IDBI and ICICI). In the financial year 2002-03, the rebates are provided at the following rates:

    (a) The rebate shall not be available in case of persons having gross total income (before deduction under Chapter -VIA) more than Rs.5 lakhs.

    (b) For persons having gross total income (before deduction under Chapter - VIA) above Rs.1,50,000 but not more than Rs.5 lakhs, the rate of rebate shall be 15%.

    (c) The rebate 20% shall continue for taxpayers having gross total income, (before deduction under Chapter - VIA) not exceeding Rs.1,50,000.

    (d) The rebate shall be higher at 30% for salaried taxpayers having gross salary income not exceeding Rs.1 lakh (before allowing deduction under Section 16) and where gross salary income is not less than 90% of the gross total income from all other sources.

The limit of qualifying investment is Rs.1 lakh with exclusive limit of Rs.30,000 for subscription to equity shares or debentures of infrastructure companies, public financial institution and mutual funds.

The effect of these provisions is that financial savings of households is generally exempted from taxation at all the three stages of savings i.e., contribution, accumulation and withdrawals[32] as would be evident from Table 10. This liberalised treatment has impacted economic efficiency, equity and revenue efforts.

The existing tax treatment of financial savings may be summarised as follows:

[32] Except instruments listed at serials number 7, 8, 10, 14 to 17 & 20 to 24 of Table 10.

Life insurance are ETE: Contributions are exempt under 88(2)(i). Accumulations are taxed.

Deferred annuity plans are EEE. Contributions are exempt under 88(2)(ii) and (iii).

Provident funds are EEE. Contributions are exempted under 88(2)(iv), 88(2)(v), 88(2)(vi).

Superannuation funds are EEE. Contributions are exempt under 88(2)(viii).

Post office savings bank deposits are EEE. Contributions are exempt under 88(2)(viii).

Securities of the central government are EEE. Contributions are exempt under 88(2)(ix). This covers any deposit scheme of the central government also.

National savings certificates are EEE. Contributions are exempt under 88(2)(x) and 88(2)(xi).

ULIP of UTI and LIC Mutual funds are EEE. Contributions are exempt under 88(2)(xii) and (xiii).

Annuities are EEE. Contributions are exempt under 88(2)(xiiia).

Units of mutual funds or UTI are EEE. Contributions are exempt under 88(2)(xiiib).

Pension funds of a mutual fund or UTI are EEE. Contributions are exempt under 88(2)(xiiic).

Deposit scheme of NHB is EEE. Contributions are exempt under 88(2)(xiv).

Deposits with HFCs, local development authorities are EEE. Contributions are exempt under 88(2)(xiva)(a) and (b).

Tuition fees are exempted under 88(2)(xivb).

Purchase of house property is EEE.

Equity and debentures of infrastructure companies is EEE. Contributions are exempt under 88(2)(xvi). This extends to mutual funds which invest in such securities, under 88(2)(xvii).

Certain pension funds of LIC are EET under Section 80 CCC.

The distortionary effects of the existing method of tax treatment of financial instruments have been extensively documented by various experts committees in the past. To summarise, the following distortionary effects have been noted with concern :

1. Saving instruments with similar maturity but different tax concessions result in different effective yields, which involve a distortion of signals for investment decisions. While investment (or saving) under Section 88 is rewarded, disinvestment (dis-saving) is not brought under charge. The incentives encourage not necessarily just savings but also diversion of funds, from one form of investment to another and that too for mere locking up these funds (i.e., surrendering the purchasing power to the government) only for a specified period of time. The netting principle is not applicable and dis-savings remain untaxed. Therefore, there is a bias in favour of investment in short-term instruments, thereby creating serious distortions in the allocation of savings.

2. The tax rebate, for repayment of instalments of housing loans made by taxpayers to specified institutions encourages debt as against ”equity” financing.

3. Some assets enjoy both deductibility in investment (under Section 88) and of interest earning (under Section 80L and section 10) leading to inordinately high effective rates of return. In turn, these serve as a benchmark for rates of return (discount rate) and therefore lead to high cost of borrowing across all sectors in the economy and to dampening of investment.

4. The special limits of Section 80L deductions applicable to government securities create legally induced distortions in the allocation of savings as between these and other assets covered by Section 80L, irrespective of the intrinsic rates of return.

5. While the major consideration behind the current incentive schemes seems to have been to encourage investment in financial assets so as to direct savings to the public sector, there are arbitrary variations in rate of return even among such assets. The rates of return bear no systematic relation to the length of the holding

period of assets. In effect, by de-linking rates of return from holding periods, the public sector crowds out the private sector through offers of quick and perceptibly safer returns.

6. Exemptions from income tax for income from capital (as under Section 80L or Section 10) is equivalent to the expenditure tax principle but a progressive expenditure tax cannot be introduced through this route. Further, if exemption for capital income is given without limit under a progressive income tax, it amounts to having a progressive income tax only on work income. Hence, the introduction of public sector bonds and other instruments and exemption on these from income tax without any limit, as is the case under Section 10, leads to unjustified distortion.

7. A differential treatment of income from dividend/interest and capital gains introduces opportunities for distorted arbitrage arising between different maturities and different coupons and also leads to window dressing opportunities for tax purposes.

8. Ideally, total return should form the basis for taxation. Moreover, certain savings instruments are more liquid than others. The resulting mis-alignment of the term structure of small saving instruments with market rates makes benchmarking more complex.

9. The existing tax treatment of saving schemes have also adversely effected the equity of the tax system. Deductions from income favour upper bracket taxpayers disproportionately. The post-incentive rates of return vary substantially across taxpayers with different marginal tax rates. In general, the post incentive rate of return increases with the marginal tax rate of the saver. These provisions are therefore, regressive.

10. To the extent exemption is allowed for roll over of capital gains, the scheme is biased in favour of taxpayers with income on capital gains. Therefore, the scheme distorts horizontal equity. Further, since the large taxpayers generally have a larger proportion of their incomes from capital gains, the rollover provisions are biased in favour of the rich thereby distorting the vertical equity of the tax structure.

11. Inequity also arises from asymmetric information about the various tax concessions for savings. To the extent information is available with a taxpayer, he is able to avail of the tax concession. This problem is particularly aggravated in the absence of adequate taxpayer education and assistance program by the tax administration.

12. The existing tax system on financial instruments is quite complex, distorting the information efficiency of capital and debt markets and providing arbitrage opportunities resulting in misallocation of financial resources. The provision of various tax exemptions for savings instruments not only increases the costs of compliance but also serves to distort economic incentives and actually hinder economic growth in the long run.

13. In their present form, tax incentives for savings, particularly for government guaranteed instruments, have the effect of increasing the floor interest rates across the economy. As a result, investment is adversely affected which in turn slows down the economic growth and employment creation[11]. Further, such incentives result in revenue loss thereby increasing the borrowings by government to meet its current expenditure. This further raises interest rates thereby crowding out private investment. Consequently, there is a slow down of investment in the economy and therefore economic growth. What appears to be micro rational is, in fact, macro irrational.

14. A case for retention of the savings incentives is built around the argument that elimination of the saving incentives will adversely affect individual's savings behaviour and therefore national savings and social security.

   This is based on the consideration that the decision to save is affected, amongst other factors, by the return on savings (net of tax).Given the pre-tax return on savings, the post-tax return depends on the marginal rate of tax on personal income. In effect, the decision to save is also determined by the marginal rate of personal income tax. An exemption/deduction for savings has the effect of increasing the post tax return on savings. While, a priori, this may be true, the impact depends on the relative strengths of the income and the substitution effects, which in turn depends upon the individual's preferences for present consumption over future consumption. Empirical evidence indicates that given the pre-tax rate of return, taxation or exemptions from taxation have no significant effects on savings. Considering the population as a whole, the income and substitution effects more or less cancel each other out. Therefore, tax exemptions for savings will not lead to enhanced national savings.

15. Apart from the costs to the economy through the adverse impacts on efficiencies and equity outlined above, tax concessions involve various economic costs to the government - in terms of interest payment and forgone revenue. below. Given the relatively short recycling period of the savings instruments, the marginal contribution to national savings of the elaborate tax exemption system is negligible, and the transaction costs it entails are considerable. Such cost are estimated to be around 40 per cent.

In any scheme of incentives for savings, it is desirable that the investments to be encouraged have broadly similar rates of return. Any variation in these rates should only be due to differences in the holding period, underlying risk or some other overriding consideration of priority for a particular sector.

An ideal income tax design entails full exemption for savings either on a TEE or EET method. Given the potential for instability inherent in the TEE method, the EET method is the most preferred option. However, the shift from the existing EEE method to EET method is likely to impose transitional administrative problems though not insurmountable.

Further, full exemption for unlimited savings, under the EET method may not fully meet the ends of vertical equity and revenue loss would also be considerable. In order to overcome these problems, the incentives are generally capped. As a result, the income tax system is not fully neutral to savings. Hence, so long as income remains the tax base, the bias against savings is inevitable but would be considerably reduced.

The wide range of tax incentives for savings are inefficient and iniquitous, calling for a comprehensive rationalisation. The apprehension about the adverse effect of the elimination of these incentives on national savings is also misplaced. Therefore, it is recommended that-

1. The tax rebate allowed u/s 88 for investment in specified schemes/instruments should be eliminated. As a result no fresh contributions to the specified schemes or investment in financial instruments would be eligible for tax rebate.

2. The deduction u/s 80L should be eliminated.

3. The exemption of interest income under sections 10(15)(i), 10(15)(iib), 10(15)(iic), 10(15)(iid), 10(15)(iv)(h) and 10(15)(iv)(i) of the Income Tax Act should be grandfathered in respect of investments already committed to these instruments/schemes.

4. The exemptions under sections 10(10D), 10(11), 10(12) and 10(13) should be grand-fathered in respect of investments already committed to these instruments/schemes.

5. The deduction under section 80CCC should be eliminated.

6. Contributions by the employer to any provident fund, superannuation fund, pension fund or gratuity fund, in excess of fifty thousand rupees per annum, should be treated as income of the employee in the year in which such contribution is made.

7. A new scheme known as the Individual Savings Account (ISA) should be introduced with the following features:-

(a) The ISA will be in two parts: Tier-I and Tier-II. The mandatory pension contributions will flow into Tier-I and will not be allowed to be withdrawn till the contributor attains the age of sixty. All other contributions will flow into Tier-II which can be withdrawn by the contributor at any time i.e there will be no lock-in period.

(b) The tax treatment of this ISA scheme(both Tier-I and Tier-II) will be on a EET method whereby contributions would be fully deductible from the taxable base, accumulations will be exempt but all withdrawals(including those in the event of death) will be included in the taxable income and taxed at the appropriate marginal rate of tax.

(c) The maximum contribution by the tax-payer or by any other person on his behalf, directly or indirectly, to this scheme will be Rs.100,000 per annum.

(d) Contributions by employer or any other person to the ISA will be treated as income and will be deductible from the taxable base within the overall ceiling of Rs.1 lakh.

(e) All withdrawals will be subject to a TDS at the rate of 20 per cent.

(f) All account holders will be required to furnish their PAN.

(g) The scheme will be operated by the Central Record Agency (CRA) to be set-up for the purposes of the new pension scheme.

(h) The Pension Fund Regulatory and Development Authority (PFRDA) will issue guidelines/rules for investment by CRA. The permissible investments will include the various schemes/instruments presently eligible for tax benefit under sections 10 and 88.

(i) The account holder will have the option to specify or alter the pattern of his investment portfolio in both Tier-I and Tier-II, at any point in time.

These recommendations relating to rationalisation of tax incentives for savings will encourage long-term savings since dis-savings will be penalised. Further, tax incentives for savings on EET method will be consistent with the long-term national debt profile. Effectively, the government will be setting apart every year a certain proportion of its tax revenues to repay its long-term debt.

5.5.5 Grandfathering of savings incentives: What does it imply?

A key aspect of the proposal for reform of tax incentives concerns grandfathering. “Grandfathering” means an alteration of the rules that apply to certain investment or investment techniques while stipulating that investment actions taken before a certain date remain subject to the old rules. For example, the law may be changed by stipulating that certain types of bonds no longer pay tax-free interest, while at the same time grandfathering the bonds issued before the date on which the new law is to take effect. The implications of this approach are as follows.

Payment of premium for life insurance policy. While the premium paid on existing policies will no longer be eligible for tax rebate after the abolition of section 88, the amount received on maturity of such policies will continue to be exempt under section 10(10D). However, the tax treatment of investment in new policies will be under the EET method of taxation.

Payment under a contract of deferred annuity. The contributions to any existing deferred annuity plan will no longer be eligible for tax rebate after the abolition of section 88. However, the tax treatment of contributions to a new deferred annuity plan will be governed by the EET method of taxation of savings.

Contributions to EPF scheme, PPF account, recognised PF, GPF and approved superannuation funds. **Contributions** to existing accounts of these funds will cease to enjoy tax rebates after the abolition of section 88. However, the interest earned on amounts outstanding in the existing accounts and withdrawals from these accounts will continue to enjoy exemption under sections 10(11), 10(12), and 10(13) of the Income Tax Act. Employees would be required to open new accounts and contributions, accumulations and withdrawals would be subjected to the EET method of treatment of savings. The number of this new account could be the old account number suffixed by the alphabet ”A”.

Subscription to any notified security or any notified deposit scheme of the central government or NSC. In these cases every lump-sum contribution is a one time investment. New investments will cease to enjoy tax rebate u/s 88. However, where income and withdrawal from these investment is exempt from income tax (other than under section 80L), the existing investments will continue to enjoy such exemptions. All new investment made in any of these securities/schemes will be governed by EET method of taxation.

Contributions to unit-linked insurance plan (ULIP). While the contributions to existing plans will no longer be eligible for tax rebate after the abolition of section 88, the amount received on maturity of such policies will continue to be exempt under section 10(10D). However, the tax treatment of investment in new plans will be under the EET method of taxation.

Subscription to notified annuity plans of insurance companies. Savings in these plans are subject to EET method of taxation. These savings will be subsumed in the proposed EET method of taxation of savings.

Contributions to any pension fund setup by mutual fund or UTI. Savings in these plans are subject to EET method of taxation. These savings will be subsumed in the proposed EET method of taxation of savings.

Tax free income from specified investments. Income from some form of investments (like tax free bonds of PSUs) is fully exempt under section 10 of the Income Tax Act. All existing investments will continue to enjoy the existing benefits. However, the new investment will be liable to the EET method of taxation of savings.

5.5.6 Taxation of fund management

Investment funds, such as mutual funds or venture capital funds, are entities owned by many persons and whose primary activity is investing in operating companies.[33] The investment fund acts as an intermediary between the individual investor and the ultimate user of the capital. Several types of investment funds exist. An ”open-end” fund issues and redeems fund units from investors. In contrast, ”closed-end” funds issue a fixed number of units, and investors trade units with other investors.

The choice of tax rules for investment funds requires balancing three objectives:

1. When a customer - such as a household or a firm - evaluates his ‘in-sourcing’ versus ‘out-sourcing’ decision, this should be undistorted

[33] Many products offered by insurance companies, which involve no actuarial aspect, are also effectively engaged in pure fund management.

by tax considations. Tax compulsions should not either prevent or encourage customers in seeking the services of professional fund managers. The decision should be based on the relative strengths and competence in fund management alone.

2. The tax rules should be comparable to those that apply to other investments. The greater the variation in the treatment of different types of income in the hands of different types of investors, the greater the pressure to tax the income directly at the investor level. Further, the lesser the variation in the tax regime by type of income in the hands of different types of investors, the stronger is the argument for simply taxing all income at the investment fund level and imposing no further taxes at the investor level.

3. The tax rules should be capable of being administered and enforced. The ability of the tax administration to develop a system to ensure enforcement and compliance with a tax regime that requires monitoring the tax consequences to many investors is much more problematic and, in many countries, may not be worth the expenditure of substantial administrative resources, given the amount of tax revenue involved.

Broadly three different approaches to taxation of income attributable to investment funds and their underlying investments, can be identified. The *first method* would be to treat the investment fund as a pass through. In its purest form, this approach treats investors as if they earned the income directly and taxes them accordingly, even if the investment fund does not distribute the income to them.This method scores high on market neutrality. However, it scores low on administrative and compliance grounds, specially as a number of investors and the number of fund investments become quite large. Therefore, no country uses this system for investment funds.

The *second method* is to tax the fund and exempt the investors.The tax on the income of the Fund is treated as a final withholding tax.This method scores high on administrative and compliance grounds but it imposes a uniform tax burden irrespective of the size of the taxpayer.

The **third method** is the full imputation method which imposes tax on the investment fund on any income it receives at a rate that could be either the highest rate applicable to investors or, alternatively, the one that is most common to investors. This approach allocates to investors their share of the income of the fund and provides a credit for taxes paid by the fund allocable to that income.Investors may then file for a refund if the amount of tax paid exceeds their liability, or they could be assessed additional tax if the amount of tax paid exceeds their liability, or they could be assessed additional tax if the amount paid by the investment fund is less than their tax liability.This variation also requires rules for calculating an investor's basis in his or her investment in the fund to determine whether an investor would recognize gain when shares are redeemed.

Under the existing system in India, the investment fund is exempted from tax. However, the dividend distributed by any mutual fund on or after 1st April, 2004 is subjected to a dividend distribution tax at the rate of 12.5 per cent.[34] The undistributed profits/surplus of the fund remain untaxed. Consequently, the existing model is not a typically pass through prototype. Dividends received by a mutual fund on investment in equities, loses its character when it becomes a part of the total income of the mutual fund.

[34]The dividend distributed by the open-ended equity fund was exempt from the dividend distribution tax of 12.5 per cent in respect of dividend distributed on or after 01-04-2003 but before 01-04-2004.

The total income when distributed to unit-holders is subjected to a distribution tax at the rate of 12.5 percent. As a result there is double taxation of dividend income(and possibly multiple taxation). The effective tax liability on dividends received through a mutual fund is higher in comparison to the liability on dividends for a direct investor. Similarly, the tax on interest income and trading profits received through a mutual fund is lower in comparison to the effective tax liability on interest for a direct investor. This opportunity for tax arbitrage encourages corporates to resort to inter-corporate lending through mutual fund. The interest is received as dividends resulting in a tax saving of 23.375 percent of the dividend/interest. If the returns are received as capital gains on sale of units, the tax liability would be substantially different.

The dividend distributed by the investment funds comprises of the following categories of income:

1. Dividends earned from investments by the Fund in equity.
2. Long-term capital gains from sale of investment.
3. Short-term capital gains from sale of investment.
4. Interest received from investment in debt.

Balancing the conflict between neutrality, simplicity and equity, and in the context of the proposed corporate tax reform, the following scheme of taxation of investment funds is recommended:

1. The tax should be levied in the hands of the fund and the investors exempted from any further liability.
2. The investment funds will maintain separate income and expenditure statements in respect of investment made by companies and non-companies.
3. The total income of the investment fund for tax purposes for both companies and non-companies should exclude dividend income received and long term capital gains.
4. Since most investors in units are generally smaller taxpayers, the rate of tax should be the minimum marginal rate of personal income tax i.e. 20 per cent. However, in the case of corporate investors, the rate of tax should be equivalent to the tax rate applicable to corporate profits.
5. With a view to overcoming double taxation, the dividends received by the unit holders should be fully exempted since the distributable surplus would have suffered the full burden of the tax in the hands of the mutual fund.
6. Both the short-term and long term capital gains arising to the investor from sale of units of investment funds should be exempt from income tax.
7. The tax treatment of mutual funds and their investors should also be extended to venture capital funds, private equity funds and hedge funds[35]. However, the tax rate for hedge funds should be 30 per cent since their investors are likely to be those in the highest tax slab.
8. All funds must necessarily report to the TIN details of investor transactions along with their PAN.

5.5.7 Redefining ‘speculative transaction’ under tax laws

With the initiation of economic reforms in 1991, ushering a paradigm shift from a closed licensed controlled economy to a free market economy, the Indian capital market has

[35]Hedge funds are structures where each customer brings in a minimum of (say) Rs.10 lakh of capital, so that the securities regulator ceases to work for investor protection, and only focuses on contract enforcement and fraud.

also undergone a sea change both in qualitative and quantitative terms. A slew of new companies entered the stock market. Simultaneously, there was also a considerable increase in the number of investors trading on the Indian bourses. As a result, the scrip-based trading set-up, which was otherwise appropriate to handle small volumes, became otiose and cumbersome. Many risks hitherto undetected, associated with voluminous paper work came to the surface in the form of bad deliveries, mutilated and forged share certificates etc. This was further compounded by the different norms for good and bad deliveries adopted by various Stock Exchanges. To deal with these problems, SEBI introduced standard Good/Bad Delivery guidelines to be followed by all Stock Exchanges and also introduced standard norms for Custodians. The process of rectifying a bad delivery was improved with the establishment of bad delivery cell acting as the intermediary for settlement of bad delivery between brokers. The above system was neither transparent nor investor friendly. It allowed the market intermediaries to undertake fictitious transactions. The system was also characterised by the absence of any audit trail i.e., lack of an effective mechanism for keeping record of transactions. Hence, the market was prone to manipulation and shifting of beneficial interest. There was also no effective system of monitoring of the activities of either the exchanges or the intermediaries. The sub-brokers, then, were not registered either with the Exchange or with SEBI and many unscrupulous ones issued bogus vouchers enabling people to generate fictitious losses.

With a view to overcoming these inefficiencies so as to bring about discipline and transparency in the exchanges and protect the interest of investors, a series of measures were initiated by SEBI. These measures, inter alia, included modernisation of the business process. Computerisation and establishment of on-line trading network via trading terminals has facilitated recording of each and every contract transacted through the exchange. Contract notes are issued to the clients on the trade date. Contract notes contain details of transactions executed and trade ID generated by the system. Each client is allotted unique client code. Each and every trade has a unique trade number generated and stored electronically by the stock exchange with all details including scrip, rate, time, value, client code and executing broker. In case of individual clients, member-brokers are required to collect his Permanent Account Number. The member-brokers are required to indicate client code while placing any order on the system on behalf of the client. The stock exchange also collect client wise margin from the member broker based on outstanding commitments in cash segment as well as derivatives segment. Thus, the transaction can be traced back and audit trail can be established. The records of the transactions are kept for seven years by the Exchanges. Audit trail was now possible thereby enabling any regulator to verify the transactions entered into the system.

Similar developments have also been taking place in the commodity exchanges. Some commodity exchanges have already installed electronic screen based trading. RBI closely monitors the trading (including derivative trading) in foreign exchange through authorised dealers. The several restrictions and disclosures are to be followed by all authorised dealers of foreign exchange.

The objective of the various initiatives to reform the capital market was to enhance the efficiency of the market system through the removal of various interventions that hitherto existed. This was intended to enable the capital market to provide greater liquidity, efficient price discovery mechanism and reduce transaction costs. The regulation of these markets was henceforth restricted to elimination of asymmetric information flows and inhibiting distortions through manipulations, rigging and fraud. The policy initiative to discourage/ban speculative transactions in the cash market and simultaneously introduce new derivative products is essentially a move to attain higher levels of market efficiency in the context of a shift from control to regulation. However, distortionary fiscal interventions contained in the Income Tax Act, 1961, continue despite extensive reforms of the capital market. Accordingly, the full impact of capital market reforms remains unrealised. It is in this context that the provisions relating to speculation have been reviewed by the committee.

Under the Income tax Act, the procedure for determining the total income of an assessee in respect of a previous year is that all income accruing or arising to the assessee and includible in his total income is separately computed under five different heads being

1. Salaries.
2. Income from house property.
3. Profits and gains of business, profession or vocation. (briefly, 'business income').
4. Capital gains.
5. Income from other sources.

Even under the same head, an assessee may have different sources of income. Thus, if an assessee carries on several businesses, the income of each and every such business has to be separately computed. Depending on whether aggregate of profits from the various sources of income exceed or fall short of aggregate of losses from other sources, the resultant would be income or loss under that head of income.

Section 71 of the 1961 Act also contemplates a mutual set off of the losses under one head against income under some other head subject to some exceptions (like speculation loss, capital loss, etc.). Thus if, in any particular assessment year, an assessee has incurred a loss under the head "Business", this loss can be set off against the income earned by the assessee during that previous year under other heads. This is the second stage in the process of assessment, which we may describe as "inter-head adjustment" or "set off". Section 72 of the 1961 Act further envisages a third stage in the process of assessment, which can be described as the process of "carry forward and set off". By this process, the assessee is permitted to carry forward a loss he has not been able to adjust or set off in the first and second stages of assessment. This benefit is not available to all kinds of losses.

In the case of a person who transacts in financial instruments, goods and foreign exchange, the above method of determination of total income is applicable provided:

1. The transaction is settled by actual delivery, unless of course the transaction is in the nature of a hedging contract. [sub-section 5 of section 43]; and
2. In the case of a company, the transaction is carried on by only such a company whose main source of Income is from a particular type of business like finance, banking etc. (Explanation to section 73).

Where the above mentioned conditions are not satisfied, the transactions are treated as speculative in nature and the profits therefrom, are subject to tax as income from speculative business. Loss from such speculative business cannot be set off against profits from a non-speculative business or any other head of income like salary, house property, capital gains and other sources. Such speculative loss can only be carried forward and set off against speculative income in the subsequent year.

Before April 1, 1953, there was no difference between speculative and non-speculative business. The Finance Act, 1953 (14 of 1953), first created that difference by inserting Explanation 2 to section 24(1) of the 1922 Act, by providing that the set off of speculation losses shall be available against profits of speculative business only and not against any other income. In the 1961 Act, this section and section 73 contain the same provisions. The effect is that if there are profits in a speculative business, these profits form part of the total income but losses in speculative business are not to be taken into account when computing the total income, except to the extent to which they can be set off against profits from other speculative business.

The basic ingredients of the definition of ‘speculative transaction’ under the Income Tax Act 1 are:

1. that the contracts are periodically or ultimately settled; and
2. the settlement would be otherwise than by actual delivery or transfer of commodity or scrip.

In other words, in order that a transaction may fall within the scope of the expression ”speculative transaction”, it must be a transaction in which a contract for purchase or sale of any commodity, including stocks and shares is periodically or ultimately settled otherwise than by the actual delivery of transfer of the commodity or script.

The effect of the definition of speculation in the Income-tax Act is two-fold:

1. where actual delivery of goods, or transfer of the commodity or scrip, takes place, the transaction is not a speculative transaction, however highly speculative it may be in fact; and
2. if the original intention was not to gamble in differences, if in fact the contract is settled by payment of the difference, it is a speculative transaction for the purposes of the Act.

The word ”settled” or ”settlement” in connection with contract has not been defined in any statute.[36]

Given the very nature of the various derivatives and the way these are structured, they are essentially not capable of actual delivery. On the other hand, many derivative products cannot be settled except by way of payment of difference. Their tax treatment, therefore, is presently surrounded with uncertainty.

Section 43(5) defines speculative transaction as one in which the contract for the sale or purchase of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrip. Derivative instruments cannot be classified as

[36]The following are some of the meanings attributed to the word ”settled” in dictionaries : ”Determined; deal effectively with; dispose of; conclude money or other transactions.”; ”To come to terms or agreement with a person”.; ”To arrange matters in dispute; to come to terms or agreement with a person. The proper meaning to be given to the words ”a contract settled” in the definition clause would be ”a contract determined or conclude or disposed of” The words do not mean that the contract is to be substituted by a fresh agreement between the parties.

commodity, stocks or shares since these are ”derived” from ”real” products. Derivatives like options and futures are not really ”stocks and shares” or ”commodities”.

Under section 2(h) of the Securities Contracts (Regulations) Act, 1956, derivatives can be described as ‘interest’ in securities. In essence, a derivative owes its existence to an already existing tangible security. However, more sophisticated derivatives like ”index-based” derivatives like ‘sensex’ or ‘nifty’ are derived from intangibles like a stock exchange indices. Thus, the existing provisions of section 43(5) do not cover transactions involving derivative instruments and therefore, trades in derivatives may not be held to be speculative under the existing section 43(5) of the Act. Indeed, in a recent judgment the Supreme Court in CIT v. Apollo Tyres (255) ITR 273 has held that trading in units is not covered by the Explanation to section 73 because units are not stocks and shares. This decision may as well apply to transactions in derivatives.

Another important aspect of section 43(5) is the use of the term ’actual delivery’. For any transaction to be treated as speculative, it should not be settled by actual delivery. Delivery being the crucial point of distinction between trading and speculative transaction may have, hitherto, held good in the context of stocks and shares. But derivatives, not being shares, are by their very nature not capable of being delivered. It is true that theoretically a ’future’ on the date of expiry may be allowed to be settled by way of delivery of the underlying scrip; but that would apply only to the last-holder of the future. During its lifetime a future may pass through several hands by settlement through price difference. Futures of sensex or nifty are in any case never capable of delivery and yet these instruments now constitute important tools of risk management by large portfolio holders. In case of options, delivery is simply not possible particularly when they lapse on account of adverse price movement. Options are also important hedge instruments. As explained elsewhere, the question as to whether future or option transaction is hedge or speculative is a vexed one specially when such transactions are large in number and are undertaken in swift succession.

A derivative transaction can be either for hedging or for speculative purpose. Therefore, assuming that derivative instruments can be brought within the purview of section 43(5), what needs to be considered is whether genuine hedging transactions in derivatives are saved by the proviso. Though theoretically the distinction between ’speculative and hedge’ is well understood, it is very difficult to distinguish many such transactions in practice. Many a transaction in derivatives when examined in isolation may appear to be speculative but when more closely examined in relation to earlier positions taken in the derivatives or in the cash markets would reveal it to be actually a hedge. Therefore, it would fall within the meaning of the term ‘hedging’ as contained in the proviso to section 43(5) assuming it is suitably amended to take care of derivatives. Controversies arising in such a scenario are likely to throw up a great deal of costly and infructuous litigation.

Speculation enhances liquidity, encourages price discovery and reduces transaction costs, it has a positive impact on the economic efficiency of the capital market. However, speculation also encourages rigging, manipulation and fraud, thereby undermining economic efficiency. The net effect depends upon the relative strength of the two. Due to the absence of any audit trail in the functioning of the stock markets, it was extremely easy to shift the incidence of tax by indulging in fictitious transactions. The unscrupulous taxpayers often sought to establish the genuineness of such transactions by procuring bogus documents from equally unscrupulous brokers. The tax administration had the onerous responsibility of disproving the genuineness of such transaction, and it often failed to do so since these could not be verified from the records of the stock exchanges. Hence a strong perception that the adverse effect of speculation was stronger than its positive effect.

With a view to discouraging such practices, a thumb rule was designed under which all transactions where delivery had not taken place were categorised as speculative in nature and the resulting losses could not be set off against any other income. Given the opacity and small size of the capital market, this form of fiscal intervention did not substantially affect the efficiency of the market. Further, experience of last several decades has shown that delivery based transactions can also be manipulated to generate artificial losses by buying them on payment of a commission. However, in the wake of a paradigm shift in the functioning of the markets there is undoubtedly a need to review this fiscal restriction.

Therefore, in the context of capital markets, the following issues need to be addressed:

1. Whether there is a need to retain a distinctive concept of 'speculative transaction' as provided in the Income Tax Act, 1961?
2. If not, what should be the anti-evasion mechanism to minimise the fall-outs of rigging, manipulation and fraud that may arise out of unbridled speculation as understood in the commercial sense?

The response to the issue at (1) above would depend upon whether our stock markets have reached the degree of transparency which alone can inhibit the past malpractices of generating fictitious losses through artificial transactions or shifting of incidence of loss from one person to another. The systemic and technological changes have brought about a qualitative shift in the trading systems. Screen based trading coupled with reforms brought about by SEBI has introduced sufficiently high degree of transparency in the stock exchanges. The Task Force therefore recommends that :

1. The present distinction between speculative transactions and non-speculative transactions should be totally dispensed with in so far as they relate to shares and securities. This recommendation should be implemented, if and only if, the various participants fulfill the following obligations:

   Obligation of the Client (a) Every client, be it investor, trader or speculator, obtains a unique client ID, which should be allotted only on the basis of PAN generated by Income Tax Department.

   (b) The trading is done electronically on screen-based systems through a recognised intermediary on a recognised exchange only during the normal trading hours of such exchange. Off-market transactions will not be recognised. However, direct exchange membership by large finance companies, such as banks or mutual funds, will be acceptable as long as it is approved by their regulator.

   (c) He must obtain from the recognised intermediary a time stamped contract note indicating the client ID.

   Obligations of the intermediary (Broker) (a) He must be an active member of a recognised stock exchange.

(b) He shall issue to every client a unique client ID only on the basis of the PAN generated by the Income Tax Department.

(c) The trading is done electronically by order matching on screen-based systems on a recognised exchange only during the normal trading hours of such exchange. Off-market transactions, which are merely registered on the screen of the exchange but not exposed to the discipline of the limit order book, will not be recognised.

(d) Any sub-broker carrying out trade on behalf of his client must get the client duly registered with the main broker and the broker shall issue contract note giving the ID number of the client and of the sub-broker. Independent contract notes or vouchers issued by the sub-brokers are not to be recognised.

(e) He shall comply with all the rules and regulations laid down by the Exchange or its regulator.

Obligations of the Exchange (a) Exchange must ensure that the particulars of the client ID are duly recorded and stored in its databases.

(b) The Exchange maintains a complete audit trail (record) of all transactions whether in the cash market or in the derivative market for a period of seven years on its system.

(c) Transactions once registered into the system shall not be allowed to be altered.

2. The obligations cast upon Exchanges should be implemented through instructions to be issued by the regulatory authorities governing exchanges like SEBI or FMC. Any Exchange not fulfilling the obligations, the loss arising out of any transaction through such an Exchange should be disallowed. Similarly, if a person does not fulfill these obligations, the claim for loss should be disallowed.

3. For tax purposes all transactions in derivative markets, should be deemed to be normal business transactions and hence assessable under the head ‘profits and gains from business or profession’. This would be so even in those cases where the stocks and shares are held in the form of ‘investments’ and not as trading stocks. However, this should be restricted to trading in all derivatives and in the shares of companies listed/traded, on the National Stock Exchange and other recognised stock exchanges on the date of acquisition (hereafter referred to as ‘specified shares’).

4. Further, trading in all other securities and the profit and loss from trading in such shares should be accounted for and computed separately. The resultant loss, if any, from such trading should be ignored for the purposes of set-off against income from any other source (including profits from trading in derivatives and specified shares) or ‘head of income’ during the same year. However, such loss can be allowed to be carried forward for set-off against income if any from trading in non-specified shares in the subsequent years. Such carry forward should be restricted to only four years.

5. In so far as other securities like units, debentures and government securities etc. are concerned, any trading loss will be allowed as normal business loss only if these are traded through recognised exchanges subject to conditions mentioned in serial number 1; or, are repurchased/redeemed etc. by the company, authority or by the Government; or, are disposed in the manner approved by the RBI, Govt. or any other prescribed authority.

Consequent to the aforesaid recommendations, traders in non-specified shares may convert stock-in-trade of such shares into investment portfolio. The subsidiary issue that needs to be addressed in this context is the cost of acquisition of such investment for the purposes of computation of capital gains. Given the fact that there is no explicit provision in the Income Tax Act for determination of the cost of acquisition in such cases, we recommend that the cost of acquisition in such cases should be the value assigned to the asset as stock-in-trade on the last day of the financial year immediately preceding the year in which the conversion takes place. An amendment to this effect will be required by way of insertion of a suitable clause in section 49 of the Act. Further, where traders in non-specified shares may convert stock-in-trade of such shares into investment portfolio, they should be allowed to exercise such an option and the Assessing Officer should not be permitted to question the decision of such a trader.

The aforesaid recommendations are relevant in so far as they relate to trading in shares and securities. The recommendations are not intended to alter the existing tax law applicable to investors in shares and securities, who will continue to be assessed to capital gains tax as per the existing law regardless of the type of shares etc. they transfer. In other words, the vast majority of investors who are assessed under provisions of Chapter relating to Capital Gains are not affected by the proposed differential treatment of 'specified' and 'non-specified' shares.

Regarding transactions in commodities and its derivatives, in 2001, the Department of Agriculture and Cooperation had set up a group of experts headed by Dr. Kalyan Raipuria, to go into areas relating to Commodity forward and futures markets and identify the constraints inhibiting the markets and suggesting measures for overcoming them. The group has since submitted its report in December 2001 and its recommendations are under consideration of the government. The group has observed that future trading in the Commodities market is presently in a state of development and it suffers from a number of limitations. These have been identified by the group to be *the limited and closed nature of membership, absence of many hedgers who have substantial underlying positions, absence of transparency (opacity) limitations of prudential regulation, absence of a legal framework for warehouse receipt system and its negotiability and transferability etc., are serious constraints under which the current system operates. Quite often, the system is criticised that no futures trading which serves the intended purpose of price discovery and risk management is currently taking place.*

With a view to remedying the existing constraints, the group has made several recommendations for bringing about professional and transparent exchanges in position. Consequently, we recommend that until the commodities exchanges implement the aforesaid recommendations and develop the requisite transparency, audit trail facilities and on-line screen based trading, etc., the provisions of section 43(5) should continue to apply to transactions in commodities. As and when the Forwards Markets Commission certifies that a particular commodity exchange has attained the same level of modernisation as those prevalent in the securities markets, trading in commodities derivatives in such commodity exchange, the losses can be allowed the same tax treatment as proposed for stock derivatives at serial numbers 1 to 3.

These recommendations are based on practical exigencies and the requirement of the present market. Thus, the revised definitions of 'speculative transaction' and 'loss in share trading' is totally artificial and do not conform to any ordinary meaning of these terms. This has been necessitated for the reason that whereas on the one hand that distinction between 'speculation' and 'non-speculation' needs to be bridged, while, on the other hand, the present malpractice of generating bogus losses requires to be curbed. These recommendations will serve this dual purpose.

It must be appreciated it is the prevention of malpractice of booking artificial losses from stock market transactions for offsetting taxable income which has been the prime objective of the legislature in treating speculative transactions as a separate business. In today's environment this object can be served, by treating all genuine transaction whether speculative or otherwise in the stock market as normal and ordinary business, but to ignore losses from such transactions which are most likely to be fraudulent or artificial. This object can be achieved by two fold conditions.

1. Ensuring that transactions take place in a transparent environment leaving behind an audit trail which cannot be erased. Hence the conditionalities recommended in serial number 1. The discipline of order matching on an electronic exchange also acts as a powerful check against the extent to which off-market prices can be introduced into trades on the "telephone market".

2. Illiquid scripts which are vulnerable to price rigging by a few individuals for generating artificial losses should be kept out. Hence, the recommendations for different tax treatment of 'unspecified shares'.

Lastly, it needs to be repeated that the vast majority of 'investors' are not affected by the committee's recommendations since they are not engaged in the business of trading in shares. The provisions relating to Capital Gains will continue to apply to them.

5.5.8 Tax issues on financing infrastructure development

Investment in infrastructure projects is constrained by the restricted opportunity to mobilize resources from capital market. Further, these projects entail large sunk costs, which can take from 10 to 30 years to recoup. Therefore, when institutions provide such funding, they are exposed to maturity mismatch, as most of their funding is through short-term deposits. The maturity mismatch in turn gives rise to both liquidity and interest risk. Therefore, promoters of infrastructure projects turn to the government to help them by relaxing the financial regulatory regime for such projects, or providing tax incentives or some sort of financial support intended to improve the cash flow or reduce risk. A large number of tax incentives for the development of infrastructure projects are already in place. Since these are distortionary in their effect, we have recommended their elimination. Given the hard budget constraint, it is difficult to allocate budgetary resources for this purpose. Therefore, it is necessary to facilitate public financial institutions to raise resources for infrastructure financing. One of the most popular method of providing finance to institution for investment in infrastructure project is the zero coupon bond.

In a conventional bond, the investor pays the face amount of the bond and receives interest payment in installments based on the coupon interest rate offered when the bond is sold. When the bond matures, the full principal amount invested is reimbursed to the investor. Unlike conventional bonds, Zero coupon bonds are bonds that are sold at a deep discount from their face value, which is the amount the bond will be worth when it ”matures” or becomes due. The issuer does not pay interest during the life of the bond. When a zero coupon bond matures, the investor receives one lump sum which is essentially equal to the initial investment plus accumulated interest compounded over the life of the bond.

The investors benefit from having a lower upfront amount to invest because the bonds are sold at a discount to their face value. This is an advantage for those investors who are just starting out or have more modest amounts to invest.

The maturity dates on zero coupon bonds are usually long-term with the majority between 8 and 20 years. These long-term maturity dates allow an investor to plan for a long-range specific objective, such as retirement, or paying for a child's higher education or marriage. Such bonds provide the investor with the ability to time the maturities to their need.

Zero coupon bonds are traded in the market and their prices fluctuate more than other types of bonds in the secondary market. This reflects changes in interest rate and the fact that no interest is paid on these bonds until maturity. Since zero coupon bonds have a long maturity period and do not entail any interest payment until maturity, these are extremely popular with agencies like the Government and corporations which undertake infrastructure projects with long gestation period. In countries like the USA, investors can purchase different kinds of zero coupon bonds in the secondary markets, which have been issued from a variety of sources like the U.S. Treasury, corporations, and state and local government entities.

In addition, although zero coupon bonds do not pay any interest until they mature, investors may still have to pay federal, state, and local income tax on the imputed or "phantom" interest that accrues each year. However, some zero coupon bonds also enjoy tax-exempt status.

Table 5.13 shows the pattern of funds mobilised by Financial Institutions[37] from the market. During the period 1992-96, zero coupon bonds were one of the main instruments for mobilizing resources. These bonds were extremely popular with investors.

In 1996 the CBDT issued a clarification on the tax treatment of zero coupon bonds. The essential features of the clarification were:

- If the investor holds the Zero Coupon Bond (ZCB) during the entire length of the maturity period, the redemption price minus the bid price (i.e. the subscription price) would be treated as interest, subject to tax.
- On transfer of the ZCB by the investor before maturity, the sale consideration minus the bid price would be treated as capital gains, subject to tax.
- For an intermediate purchaser, the difference between the purchase consideration and redemption would be treated as interest.
- The difference between the redemption price and the bid price would be subjected to Tax Deduction at Source (TDS) on maturity.

Later, in 2002, the CBDT revised the 1996 clarification and prescribed a new tax regime for ZCBs. Under the new regime:

- The initial subscriber is liable to tax on the accrued interest. The accrued interest is calculated as the difference between the market valuations on two successive valuation dates. The valuation date for this purpose is the last day of the financial year.
- The inter-mediate purchaser is liable to tax on the difference between the market value on the

[37] This excludes companies which have raised funds through private placement.

Table 5.13 Funds mobilised by financial institutions through ZCBs

(Rs.crore)

Issuer	Date	Total	Through DDBs	%	Number of Applications
IDBI	Jan-92	480.0	452.9	94.4%	
SIDBI	Nov-92	166.9	160.6	96.3%	445,856
Sardar Sarovar	Nov-93	570.2	279.0	48.9%	565,280
IDBI Flexi	Feb-96	1,511.0	896.5	59.3%	
ICICI	May-96	448.3	112.5	25.1%	190,107
ICICI (Pvt Placement)	May-96	623.5	218.2	35.0%	333,214
IFCI	Jul-96	1,237.0	396.2	32.0%	510,688
L&T	Sep-96	504.7	101.7	20.1%	57,095
TISCO	Sep-96	500.0	164.5	32.9%	92,225
MKVDC	Nov-96	389.5	166.0	42.6%	196,117
IDBI Flexi 2	Jan-97	1,682.5	140.0	8.3%	178,152
ICICI	Mar-97	3,444.6	113.3	3.3%	162,060
ICICI	Dec-97	343.5	65.8	19.1%	35,197
ICICI	Mar-98	576.5	90.1	15.6%	57,695
ICICI	Apr-98	422.2	72.2	17.1%	28,490
ICICI	Jul-98	504.4	83.3	16.5%	63,304
Total		13,404.8	3,512.7	26.2%	

valuation date and the cost of purchase. The cost of purchase for this purpose will be the cost to the transferor plus income offered for tax by the transferor, up-to the date of transfer. The gain during the broken period is to be treated as short-term capital gain.

- The difference between the redemption price and the bid price would be subjected to Tax Deduction at Source (TDS) on maturity.

However, the tax regime prescribed by the 1996 clarification continues to apply to small investors with an investment ceiling of one lakh rupees.

Both the 1996 and 2002 clarifications have resulted in discriminatory tax treatment of gains from zero coupon bonds as compared to tax treatment of gains from conventional bonds. Therefore, there has been a change in investors' preference in favor of regular return bond i.e. conventional bond. Bond issuing agencies have ceased to use this instrument for mobilizing long-term resources.

The 1996 clarification violated the principle of fiscal neutrality fundamental to the design of any tax provision. In the case of an investor holding the zero coupon bond till the eve of its maturity, the gains were characterised as capital gains and therefore subjected to concessional tax treatment by providing for inflation indexing and allowance for bunching of gains. The resulting effective tax liability was extremely low. However, in case the investor held the zero coupon bond till maturity, the entire gain (including the gains which have accumulated till the eve of maturity) was treated as interest thereby attracting the full tax liability. No allowance was made for the fact that the gains accumulated over a long period of time and therefore suffered substantial erosion in their real value or for bunching of gains resulting in bracket creep. The tax treatment in the latter case was anomalous giving rise to economic distortion and inequity.

Attempting to resolve the problem posed

by the 1996 clarification, the remedial clarification in 2002 did not go a long way. The conflict between higher revenues and fiscal neutrality in tax policy was typically resolved in favor of higher revenues. All gains are to be treated as interest and taxed on accrual basis and capital gains if any will be short term. Consequently, all investors will now suffer the adverse consequences flowing from economic distortion and inequity.

The 2002 clarification has given rise to new problems without resolving the old ones. These are:

Liquidity mismatch Generally, individual taxpayers follow a cash method for accounting gains on investments. However, the 2002 regime provides for taxing the gains from ZCBs on accrual basis, irrespective of the method of accounting regularly followed by the taxpayer. To the extent tax has to be paid on accrued income, it results in liquidity/cash flow mismatch. Therefore, the present regime is biased against the cash method of accounting.

Distort period of holding Investor's choice of the period of holding is also influenced by the tax treatment of gains from zero coupon bonds. The amount of income from ZCBs increases exponentially with the increase in the holding period and consequential increase in tax liability and associated problem of cash flow. Investors have an incentive to liquidate ZCBs over a relatively short holding period.

Timing mismatch Further, investors who hold bonds for the maturity period are subjected to the additional rigors of withholding tax (TDS) on the entire gain over the maturity period even though the investor has paid the tax on such gains on accrual basis. The taxpayer is also subjected to an additional compliance burden of filing tax return and obtaining refund. Consequently, the tax administration with its limited resources is put to considerable strain of processing refunds. Given the transaction costs associated with compliance, the design of the withholding tax on ZCBs imposes relatively greater compliance burden on small investors. Therefore, these rules are violative of both horizontal and vertical equity. The existing tax regime for ZCBs is, accordingly, inefficient and burdensome for both taxpayer and tax administration.

Enhance liquidity risk for borrowers An investor in any other fixed income cumulative scheme is generally allowed to have a choice of the method of accounting. Taxpayers with same income and under similar circumstances are treated differently. It makes eminent sense for an ordinary investor to prefer bonds of relatively small maturity period with a put option. All borrowers, including those engaged in infrastructure, are therefore under pressure to respond to such demands. In the infrastructure sector, this often creates liquidity mismatch for the borrower and exposes him to liquidity risk.

It is necessary to correct these distortions in the tax treatment of ZCBs by designing a new tax regime based on the fundamental principle of fiscal neutrality. In theory, when accrued gains are received after a long period of time, appropriate adjustment for inflation and bunching of gains need to be provided. This is similar to the tax treatment of capital gains on transfer of assets. We therefore, recommend that:

1. All gains from ZCBs listed in the market may be treated as capital gains and subjected to tax as short-term gains or long-term gains depending upon the period of holding.
2. All ZCB issues should be dematerialised.
3. It should be mandatory for all investors in ZCBs to quote their PAN.
4. The amount paid on maturity may be exempted from Tax Deduction at Source (TDS).
5. In view of the broad-basing of the personal income tax rate structure, there is no case for providing any separate relief for bunching of income.

The proposed regime is neutral to the method of accounting, period of holding, size of the taxpayer, and maturity period. While providing for exemption from TDS, adequate safeguard is provided against tax evasion through the requirement of quoting PAN and dematerialisation. Therefore, the proposal is both efficient and equitable.

Institutions like IDFC, IDBI, NABARD and similar agencies could be allowed to issue these bonds and if necessary RBI could also be allowed to subscribe to the primary issues. Such large scale mobilisation of resources by institutions engaged in infrastructure financing would help to finance the public investment programs for roads, metros, airports, power sector and agri-infrastructure.

5.6 Corporate tax

In most countries with income taxation, corporate entities are subject to tax on their profits and, in addition, dividends are taxed in the hands of shareholders (subject to exemption up to a point). The base of the corporate income tax, however, is commonly the accounting profits derived with reference to historical costs. Certain modifications are also often made by law to accounting profits to provide incentives for activities considered important for social and economic policies or to provide relief from inflation as well as to curb misuse of the corporate form to reduce personal tax liability. From an economic point of view, the main issue of substance in this area, however, is not the legal form of the tax on the incomes of different entities but rather the extent to which provisions are made under the corporate income tax, the personal income tax, or both, to reduce or eliminate ”double taxation” of income which is earned by a corporation but accrues in one form or another to the individuals who are its ultimate owners. Under a system of general income taxation, whether companies should be taxed independently as separate entitles has been the subject matter of prolonged debate among tax economists. One view is that since corporations are not persons, strictly speaking, there is no case in equity for taxing the profits of companies as such. The tax should be levied only on the owners, that is, the equity holders, by attributing the profits of the companies to the shareholders. Such a system, however, can operate smoothly only if all profits are distributed every year among the shareholders. Where part of the profits is retained, the gain to the shareholders accruing from appreciation in the value of equities escapes taxation unless there is an effective tax on realised capital gains or unless the undistributed profits are attributed notionally to the shareholders. This is not simple in the case of large corporations in which the shares undergo sale or transfer all the time.

Since capital gains are usually treated preferentially, even where the income tax is levied on capital gains, exclusion of retained profits of companies from taxation provides an easy way of avoiding taxation by accumulating profits under the corporate cover. Taxation on the basis of attribution also encounters problems in the determination of capital gains when the shares are transferred, as the cost basis has to be adjusted annually to take account of the notional distribution of accumulated profits underlying the capital gain. Besides, taxation on notional basis gives rise to liquidity problems and hence does not seem equitable or feasible. It is therefore generally accepted that some tax has to be levied on the profits of companies so long as individuals and unincorporated enterprises are subjected to tax on their profits.

Taxation of Companies as Separate Entities is also justified as a withholding tax, which may be a useful means of ensuring that income flowing through the conduit is taxed in a comprehensive and timely manner and that the base of the individual income tax is protected. Many economists, including some who have not advocated full integration, have argued that this withholding function is indeed the main argument for the imposition of a tax on corporate income.

A separate tax on the profits of companies is considered reasonable also on the ground that incorporation confers substantial benefits such as limited liability of shareholders, right to sue and be sued and so on. What is more, corporate taxation is an administratively simple device for taxing an important type of income from capital.

Tax should be levied, as a matter of fiscal equity, according to ”ability to pay” - as measured by income. Further, corporate entities do not have an ability to pay taxes, in the relevant sense; they are simply a ”conduit” through which income flows to individuals who are their ultimate owners. Combined, these propositions appear to suggest that corporate income should only be taxed in the hands of the individuals to whom it accrues. Hence, there is a case for integrating individual and corporate income taxes.

In particular circumstances, full integration could be achieved in principle by several systems. One such system would be to abolish the corporate income tax completely and let shareholders pay taxes under the personal income tax on the dividends received plus net accrued capital gains on shares - that is, on a comprehensive income base. However, such a system is extremely burdensome in terms of both administrative and compliance cost. Further, it will also lead to considerable revenue loss, particularly in the transition, since the income in the hands of the shareholders will be very thinly distributed. Second, full integration could be achieved straightforwardly, in the special case where the personal income tax is levied at a single rate, by levying tax on corporate income at the same rate, while exempting dividends and capital gains on company shares from the personal tax. Such a corporate tax should serve as a scheduler final tax on income from equity capital.

The results of the full integration method can also be substantially achieved in a two rate personal income tax structure where the corporate tax is levied at the higher of the two rates and it is assumed that most (if not all) individual shareholders are subjected to tax at the highest marginal rate of personal income tax. Under this system, a company would not be able to defer tax simply by not paying dividends and therefore there would not be any loss of efficiency. Further, because the number of corporate entities are few then there are individual shareholders, and because they are more easily identifiable, having a corporate as a principal taxpayer makes administration much easier than having only the investors as legal taxpayers. It also makes it much easier for the tax administration to distribute refunds or collect adjustment resulting from scrutiny assessments (audit). In view of the above, textbfwe recommend the adoption of this method of full integration of corporation or personal income tax, that is, levy a tax at the corporate level at the rate of 30 per cent being the maximum rate of personal income tax and exempt all dividends and long-term capital gains from tax in the hands of the shareholders. This method would not undermine any equity since most direct equity investors in the companies in India are likely to be taxed at the top marginal rate of personal income tax.

5.6.1 Tax incentives

The source of the problem of double taxation is, therefore, tax incentives, which are a prominent feature of many tax codes in both developed and developing countries. Tax incentives have been used by countries to achieve a variety of different objectives, not all which are equally compelling on conceptual grounds. Such incentives have either been for stimulating investment in general, or as a matter of economic or social policy and addressing regional development needs. Quite often, countries pursue multiple objectives with overlapping tax incentives.

An investor's decision to invest is influenced by several factors which could be grouped into four broad categories: (i) tax-related considerations, (ii) non-tax related considerations, (iii) non- economic consideration, and (iv) social policy consideration.

Tax-related considerations refer to features in the tax system as a whole that impact on the effective tax burdens on investment projects. If there are limitations in these features that impede investment, the first-best policy is to correct the limitations directly via appropriate tax reform, rather than to compensate for them through enacting tax incentives. If, for example, depreciation allowances are too restrictive or the corporate income tax rate is too high in relation to international norms, then restructuring depreciation allowances or lowering the CIT rate to competitive levels would be far more preferable than introducing tax incentives in restoring a favorable investment climate.

Non-tax related economic consideration refer to those that affect either the general macroeconomic or the microeconomic/structural environment, or both. If there are deficiencies in these environments that impede investment, the first-best policy is to implement sound macroeconomic policies and / or undertake relevant structural reforms, rather than to resort to tax incentives that do not address the root-caused of the deficiencies. For example, large budgetary imbalances can raise questions about the sustainability of present tax rates, and high inflation rates can generate considerable uncertainty about prospective macroeconomic developments. Likewise, rigidities in labour markets can raise labour costs above internationally competitive levels, rigidities in labor markets can raise prospective macroeconomic developments. Likewise, rigidities in labour markets can raise labor costs above internationally competitive levels, and poor communication and transportation infrastructures can increase the costs of doing business significantly. When such macroeconomic imbalances occur and / or structural deficiencies exist, tax incentives alone are unlikely to provide sufficient underpinning for investors' confidence - they may, in fact, be counterproductive if investors view them as steps in the wrong direction for addressing the underlying problems. Tax incentives attempt to overcome structural rigidities by pushing fundamental reform to the background.

Non-economic considerations refer to those related to the legal, regulatory and political economy environment. These considerations are often as important as tax and other economic considerations in fostering an environment that is conducive to investment. For example, investors are frequently concerned about the clarity of the law that governs the investment regime, and the transparency with which regulations (rules and procedures) associated with the investment law are enforced. Again, if there are deficiencies in this environment that impede investment, the first-best policy is to undertake corrective actions to remove the deficiencies. Investors' concerns about deficient legislation and onerous regulations, as well as perception of corruption on the part of those officials responsible for approving investment projects, can seldom be overcome by the availability of even generous tax incentives.

Social policy consideration refers to those that arise from equity concerns. Producers in certain sectors (e.g., agriculture) may be regarded as economically disadvantaged relative to other, more developed sectors (e.g., industry), and the provision of tax inventives to the former sectors may be considered as a way to advance equity objectives. However, such objectives can be more effectively addressed by an appropriately designed expenditure policy that targets individual on the basis of their levels, rather than by tax incentives that target economic activities on a sectoral level. The above discussions suggest that tax incentives are often not the first-best policy instrument to achieve the kind of objectives that they have commonly been used for.

The case for tax incentives is justified on several arguments. First, an economically compelling justification for the use of tax incentives is the rectification of market failures. Specifically, there are some types of investments that generate positive externalities (benefits that the market fails to internalize) for the economy as a whole. Since the amount of such investments would be socially sub-optimal if left entirely to market forces, tax incentives could be used as a corrective policy instrument to encourage such investments. Second, in small and open economies with mobile capital, the incidence of any tax on capital income would be shifted to less mobile factors such as labour, in which case it would be better to tax the latter factors directly rather than indirectly by taxing capital income.[38]

Once the need for granting tax incentives is accepted, questions about targeting and measurement will inevitably arise. For example, how would one go about identifying investment projects that would generate the kinds of positive externalities that are deemed to be deserving of tax incentives? Once identified, how would the externalities be measured so as to determine that appropriate amount of tax incentives to be granted? These questions have no easy and clear cut answers, but they need to be resolved, by a rational and objective decision-making process informed of all relevant facts and constraints.

A crucial consideration that bears on the decision to grant tax incentives should be their cost-effectiveness. Their use should be predicated on the belief that the benefits to the economy that can be expected from an increase (if any) in the incentive-favored

[38]However, even in such economies, having some form of a Corporate Income Tax could be essential as a backstop to labor taxes to prevent the artificial shifting of income from labor to corporations (e.g., owners of firms could incorporate, transform their wage income into corporate retained earnings, and receive returns in the form of capital gains from selling their shares). The optimal form of the CIT under these circumstances would be a cash flow tax. The granting of certain forms of tax incentives could then be viewed as a means of achieving this end.

activities would actually outweigh the total costs of the tax incentives granted.

Granting tax incentives entails four types of costs : (1) distortions between investments granted incentives and those without incentives; (2) forgone revenue (on the assumption that the government operates under a revenue constraint, so that the lost revenue would have to be compensated from alternative distortive taxes); (3) administrative resources required to administer them; and (4) the social costs of corruption and/or rent-seeking activities connected with abuse of tax incentive provisions. While these costs could be substantial, the benefits to the economy that could be attributed solely to tax incentives are less clear and not easily quantifiable. Hence, the cost-effectiveness of tax incentives is often questionable. The distortion cost of the incentives could arise even if such incentives are used to correct for externalities, since the amount of incentives granted may not conform exactly to the extent of the externalities involved, due to the inherent difficulties in measuring the latter. By extension, such costs would also arise whenever tax incentives are erroneously granted to investment projects with no positive externalities, as could happen (for example) through abuse and leakage in the system.

The revenue costs of tax incentives have two different dimensions. First, investment projects could have been undertaken even if there had been no tax incentives. For these projects, which typically comprise those of the highest profitability and, therefore, having the greatest economic merits, the availability of tax incentives would simply represent a free gift from the government to either the investors or, if they are of foreign origin, the treasury of their home countries. The latter outcome would come about if any income that is spared from taxation by the host country is taxed by the investor's home countries - as it would be the case than these countries have tax systems that are based on the residence principle. The second dimension of the revenue costs of tax incentives is that, even when tax incentives are ineffective in attracting additional investments perhaps because of their failure to overcome other impediments to investment, they may still entail a revenue loss because their mere availability opens the door to potential abuse by investors not eligible to receive them.

The administrative cost of tax incentives flow from the need to divert scarce administrative resources to administer tax incentives. Indeed, abuse and leakage are perennial problems with tax incentives, and their effective prevention can often absorb a substantial amount of quality administrative resources - a scarce commodity in most developing countries. The more scare resources are devoted to administering tax incentives, the more other important administrative tasks would be impaired - thus jeopardizing tax collection as a whole. These costs would clearly escalate with increased scope and complexity of the tax incentives provided, if the aim is to properly enforce them. The social cost of incentive provisions often has to do with both the unofficial condoning - or even encouragement - of abuse of such provisions by officials charged with the responsibility for their administration. Tax incentives also inevitably induce socially unproductive rent-seeking behavior. Once the incentive system gets going, those who are fortunate enough to have captured the rents will have an inherent interest to maintain the status quo. This explains, quite apart from economic reasons, why it is so difficult in reality to terminate or even phase out tax incentives once they are granted, even if such incentives are formally time-bound. The most effective way of overcoming these political economy problems of tax incentives is to ensure that the incentive-granting process is transparent and has accountability. Unfortunately, in most developing countries such process do not exist primarily due to lack of institutional capacity.

Tax incentives are, therefore, inefficient, inequitous, impose greater taxpayer compliance burden and administrative burden, result in revenue loss and complexity of the tax laws, and encourage tax avoidance and rent seeking behaviour. It is best that they are fully eliminated from the tax statute.

At present, the Income Tax Act is riddled with tax concessions, which take the form of full or partial exemptions, deductions, and tax. The efficacy of the incentives has been examined and their adverse impact well documented in the numerous reports of Committees, Task Force, and Study groups. A cursory look at the annual report of the Comptroller and Auditor General of India in respect of the Income Tax Department will bear out the fact that these incentives have become a source of abuse. The mounting appeals at all levels are an eloquent testimony to the complexity and the ambiguity in the tax law on account of the various incentives. The erosion in the tax base is evidenced by the divergence between the statutory corporate tax rate and the effective tax rate (Table 5.14).[39] Such divergence between taxable income and book profit also undermines corporate governance. Inspite of these distortions caused by the various tax incentives, these have continued.[40]

These concessions may have been justified in the era when the marginal tax rates were exorbitantly high. However, over the year the marginal corporate tax rates have been reduced substantially. Therefore, the exemptions and notional deductions should be discouraged and wherever necessary political environment created to purge the tax statute of such incentives. It is important to review the large number of these exemptions/deductions/holidays so as to expand the tax base and also increase the average tax liability. Given the government's bold initiative in eliminating the incentives relating to exports of goods and services, the die is now cast for eliminating other incentives.[41]

The divergence between the statutory tax rate and the effective corporate tax rate is primarily accounted by (i) accelerated depreciation;(ii) incentives for goods and services produced in and exported from, FTZ, SEZ,HTP and STP (sections 10A and 10B); (iii) incentives for export of goods and services (sections 80HHC, 80HHD, 80HHE, 80R, 80RR and 80RRA); and (iv) incentives for backward area development, infrastructure etc (section 80IA and 80IB).

[39] This is inspite of the provisions of Minimum Alternate Tax (MAT) which is, in itself, a sore point with trade and industry.

[40] Introduction of tax incentives creates a clientele for their continuation and spread. The fact that many industrial countries maintain some tax incentives after the tax reforms of the 1980s is less a statement that they are considered to be effective and more a testament to the political difficulty in removing them once they have been introduced. It is because of this tendency that many "temporary" measures, designed to respond to particular perceived disincentives, remain in force long after the conditions that originally led to their introduction have changed.

[41] Report of the Advisory Group on Tax Policy and Tax Administration.

Table 5.14 Trends in the effective corporate tax rate

Year	Statutory rate	Effective corporate tax rate	
		Manufacturing	Banking & Finance
1996-97	43.00	21.36	26.82
1997-98	35.00	20.85	25.55
1998-99	35.00	21.40	21.55
1999-00	38.50	21.29	24.75
2000-01	39.55	21.00	27.88
2001-02	35.70	19.62	30.22
2002-03	36.75	23.53	28.11

5.6.2 Accelerated depreciation

The definition of income or profit for tax purposes is mainly based on the accounting practices on the one hand and the administrative limitations on the other. As far as the corporation is concerned, the problem is the presentation of the net profit, which is the gross earning minus the costs plus the capital gains. Thus the essential idea underlying the concept of income for tax purposes is, not only the severance of the current costs but also the separation of capital costs from the total gains. The determination of costs, therefore, is the most important problem in the calculation of total taxable income. Such an exercise relates more in particular to valuation of the cost elements. Current cost elements like raw material, wages, salaries, rent etc do not pose any valuation problem since these are fully consumed almost immediately or in the year of acquisition.

The problem of the ultimate taxable income could be resolved only by the valuation of the current assets and the fixed assets. The valuation of the opening and closing inventories of a firm is the determinant of the cost of goods sold and thus of the net income. Usually inventories will be valued at the lower of the cost or market value method. However, this method tends to exaggerate the profit or loss in times of sudden or sharp shifts in the price level. Even though from a long run point of view the imaginary profits and losses will cancel out one another, they will nevertheless create special problems during the short run period. Alternatively, the ’first-in-first-out’ method and the ‘last-in-last-out’ method are used in inventory valuation even though these do not fully meet the requirements of all kinds of businesses. Ultimately, however, the problem of inventory valuation arises solely due to changes in the price level. If only a stable price level could be maintained, then inventory valuation would not present such a problem.

The capital goods used in the production of commodities naturally wear out. Invariably, owing to the passage of time, the equipment used becomes obsolete. Moreover, in industries like mining, forestry etc., the marketable materials such as oil deposits, coal, and timber come to be completely used up in course of time. Income from such industries is actually derived from the sales of capital itself, though in infinitesimal parts. This creates the problem of the wearing out or depletion of capital.

Such being the case, the extent of wearing out, obsolescence and depletion should also be included in the current costs of production, and such costs should be deducted from the gross earnings. Depreciation is deducted in order to permit the tax payer to recover intact and free from income-tax his capital investment in plant and equipment. In principle depreciation should reflect the decrease in the value of the capital arising from weathering, wear and tear, exhaustion of useful life obsolescence. Ultimately, the sum of all depreciation deductions plus the scrap value will equal the cost of replacing the same asset when its useful life has been exhausted. In theory, if depreciation is correctly calculated, there could never be any capital gain or loss, since the cost or basis of the property, adjusted by such a depreciation allowance, would always equal the works value.

However, this does not happen in every case, the main difficulty here is the inadequacy of our tools to measure the amount of destruction and also to provide the norm. In calculating depreciation allowances, many estimates have to be made, like the life of the asset and the cost of replacing the asset in the future. Apart from these, changing price levels create a host of other problems. Some times, again, overstatement of profits and understatement of depreciation allowances occur owing to a price rise. As a general rule, conditions of inflation or deflation tend to distort profit and loss reports, because of their effects on depreciation, inventory valuation, etc. It is also possible that considerable amounts have been set aside for the maintenance of the capital equipment, and this must reflect in the depreciation allowances. If even larger amounts are spent for the upkeep of the machinery, naturally the value will decline less rapidly, and consequently less should be deducted from depreciation.

Therefore, the underlying objective of depreciation is to enable a fund to be built-up, free of tax, which fully meets the replacement cost and thus neutralize the erosion in physical capital in the course of business. An appropriate depreciation rate that ensures an adequate accretion to such fund is essentially a function of variables such as rate of inflation, nominal interest rate, corporate tax rate and the normal duration of replacement period. If the price level over the period of use of the capital asset was stable, the replacement cost would be equal to the original price and therefore the need for estimating the future replacement cost would not arise. If replacements fall due to a period of extended inflation, the normal depreciation reserves will obviously be inadequate relatively to the requirements of replacement of assets (even by like assets), as prices would have substantially increased. Therefore, depreciation allowance would be understated resulting in over-reporting of real profits and over-taxation. The shortfall has to be met by raising external finance and/or by diverting other reserves, to enable a business to preserve intact its physical assets. In countries characterised by high corporate tax rates, the scope for building up reserves in itself is extremely limited. Similarly, in the absence of an efficient capital market, the scope for raising external finance is restricted. Even if an efficient capital market existed, a high debt equity ratio increases risk of investment and therefore the cost of capital thereby rendering new investment uneconomical. In such circumstances, both production and revenues would be affected adversely. Similarly, higher nominal interest rates add to the tax free fund but also result in higher cost of capital. The net impact is more often likely to dampen investment decisions. The length of the adjustment lag also affect accretion to the fund. If the rate of accretion is to be maintained in the face of increasing inflation, government must respond swiftly by making corresponding changes in corporate tax rates and depreciation rates. To the extent the response is delayed, accretion would be adversely affected.

The Income Tax Act read with the Income Tax Rules classifies capital assets into a basket of different assets and provides different percentage rates of depreciation for each such basket (known as a block of assets). The depreciable amount is determined on the declining-balance method. The general rate of depreciation for plant and machinery under the tax law is 25 per cent. This was first prescribed in 1991-92. Such high rate of depreciation was justified in 1991-92 because of the high corporate tax rate of 51.75 per cent which adversely affected internal accrual of resources for replacement and modernisation. Consequent to our recommendation to reduce the corporate tax rate to 30 per cent from the existing levels of 36.75 per cent, it is now necessary to review the general rate of depreciation for plant and machinery.

The adequacy of the rate of depreciation depends on the (presumed) period of the useful life of the asset, the mode of granting depreciation, i.e., whether by the diminishing balance method or by the straight line method, and the past and expected rates of growth of prices of capital goods. For the general category of plant and machinery, it would seem reasonable to assume an average period of service life of ten years. Although in practice, machinery has come to be replaced in industry after a period much longer than ten years, nevertheless, in view of the rapidity of technological change, it would be prudent to keep in mind the notional period of ten years of useful life for machinery. Having made this assumption, we should aim at a shorter recovery period through higher or accelerated rate of depreciation. When this is done, the interest (net of tax) earned on the amounts recovered should also be taken into account in computing the accumulated balance at the end of the presumed life of the assets.

For the purposes of an illustrative calculation, we assume the rate of interest under the prevailing circumstances at 8 per cent, subject to tax at the corporate tax rate of 35.875 per cent. We find that depreciation allowances granted at 25 per cent on the basis of the diminishing balance method and CENVAT credit for capital goods spread over two years, if invested at 8 per cent rate of interest, would yield an accumulated balance at the end of ten years of Rs.153.37 net of tax on interest, for an original cost of Rs.100 including a CENVAT of Rs.12.54 and a state VAT of Rs.9.09 (Table 5.15).[42] These accumulated internal accruals from depreciation would be further augmented by the scrap value of Rs.4.41, thereby providing a total accrual of Rs.158.29.

Assuming the rate of inflation in the price of capital goods at 3 per cent per annum,[43] the replacement value of the capital asset at the end of the period of ten years is estimated to be Rs. 130.48. The internal accruals therefore are far in excess of the replacement value. With corporate tax rate proposed to

[42]We assume a CENVAT rate of 16 per cent and a state VAT of 10 per cent on capital goods. We also assume that the credit against CENVAT on capital goods will be spread over two years and in the case of state VAT over a period of three years.

[43]The rate of inflation in the price of capital goods was 2.87 per cent per annum during the ten year period 1994-95 to 2003-04.

Table 5.15 Calculation of accumulated internal accrual under the existing corporate tax regime (2003-04)

Financial Year :	2003-04
Capital Cost	100
Interest Rate Applied(current Year)	8%
Depreciation	25%
Corporate Tax Rate	35.88%
Inflation (Capital Goods)(Preceding Year)	3.00%
Number of years over which CENVAT Credit is spread out	2
Number of years over which State VAT Credit is spread out	0

Amount in Rs.

Year	Asset value at the beginning of the year	CENVAT	State VAT	Depreciation (Declining Balance)				Interest	Tax on Interest	Interest Net of Tax	Accumulated internal accruals at the end of the year	Residual value at the end of the year	Accumulated internal accruals at the end of the year	Replacement value of Machinery
				Cost	CENVAT Credit	State VAT credit	Total							
1	78.37	12.54	9.09	19.59	6.27	2.27	28.14	0.00	0.00	0.00	28.14	71.87	100.00	100.00
2	58.78	6.27	6.82	14.69	6.27	1.70	22.67	2.25	0.81	1.44	52.25	49.20	101.44	103.00
3	44.08	0.00	5.11	11.02	0.00	1.28	12.30	4.18	1.50	3.37	67.92	36.90	104.82	106.09
4	33.06	0.00	3.83	8.27	0.00	0.96	9.22	5.43	1.95	4.63	81.77	27.67	109.44	109.27
5	24.80	0.00	2.88	6.20	0.00	0.72	6.92	6.54	2.35	5.73	94.42	20.75	115.18	112.55
6	18.60	0.00	2.16	4.65	0.00	0.54	5.19	7.55	2.71	6.75	106.36	15.57	121.92	115.93
7	13.95	0.00	1.62	3.49	0.00	0.40	3.89	8.51	3.05	7.70	117.95	11.67	129.62	119.41
8	10.46	0.00	1.21	2.62	0.00	0.30	2.92	9.44	3.39	8.63	129.50	8.76	138.25	122.99
9	7.85	0.00	0.91	1.96	0.00	0.23	2.19	10.36	3.72	9.55	141.24	6.57	147.80	126.68
10	5.88	0.00	0.68	1.47	0.00	0.17	1.64	11.30	4.05	10.49	153.37	4.93	158.29	130.48
11	4.41	0.00	0.51	1.10	0.00	0.13	1.23	12.27	4.40	11.46	166.06	3.69	169.76	134.39
12	3.31	0.00	0.38	0.83	0.00	0.10	0.92	13.29	4.77	12.48	179.46	2.77	182.23	138.42
13	2.48	0.00	0.29	0.62	0.00	0.07	0.69	14.36	5.15	13.55	193.71	2.08	195.78	142.58
14	1.86	0.00	0.22	0.47	0.00	0.05	0.52	15.50	5.56	14.69	208.91	1.56	210.47	146.85
15	1.40	0.00	0.16	0.35	0.00	0.04	0.39	16.71	6.00	15.91	225.21	1.17	226.38	151.26

be reduced to 30 per cent, the total internal accruals will further increase. As a result, there is a case for reviewing the rates of depreciation for income tax purposes.

Table 5.16 shows the computation of the internal accruals at the end of each year under the proposed new tax regime i.e., reduction in the corporate tax rate to 30 per cent, reduction in depreciation rate to 15 per cent and CENVAT credit for capital goods to be fully allowed in the first year. The accumulated internal accruals from depreciation (Rs.129.29) plus the scrap value (Rs. 15.43) at the end of ten years is Rs.146.51 as against the replacement value of Rs.130.48. The internal accruals under the new circumstances will be lower than those under existing tax regime but will continue to be higher then the replacement value. The internal accruals will further improve once state VAT is in place. Moreover, reduction in corporate tax rates would also result in increased retained earnings (assuming unchanged dividend pay-out ratio) which should enable the corporates to finance replacement and modernisation.

It is therefore apparent that the proposed corporate tax regime will not adversely affect the economics of investment in plant and equipment i.e., physical assets as it continues to ensure adequate accretion to the fund. Further, there is also a strategic advantage. The knowledge and human capital are now emerging as important determinants in deciding country's international competitiveness. The bias against knowledge and human capital under the existing corporate tax regime will also be considerably reduced, thereby enhancing India's competitiveness.

In view of the above, we recommend that the general rate of depreciation for plant and machinery should be reduced to 15 per cent from the existing level of 25 per cent. We also recommend that the rates of depreciation for other blocks of assets must be reviewed along the above lines.

5.6.3 Tax incentives under sections 80IA and 80IB

The deductions u/s 80IA and 80IB are allowed in respect of profits from the eligible business at the rates and for the number of years as indicated in Table 14. We have, in preceding paragraphs, discussed elaborately the rationale for eliminating tax incentives from the tax statute. The case for removal of the incentives under section 80IA and 80IB is built around the following arguments:-

1. These deductions, in so far as they relate to backward areas and other specific locations, have not served their intended objective.[44] Similarly, like any other incentives, these also cause serious distortions in economic efficiency, equity and administrative effectiveness. If incentive for development of backward areas need to be protected, the objective would be well served by an expenditure grant either in the form of a capital or output subsidy. Such an incentive mechanism would be relatively more efficient and equitable.

2. The eligible businesses referred in sections 80IA and 80IB are businesses having long gestation period and generate huge losses in the first five to seven years. Therefore the tax benefit from such losses is often lost out due to the arbitrary cut off period for carry forward and allowability of losses. This problem could be resolved by allowing business losses to be carried forward indefinitely, as in the case of depreciation.

[44] Planning Commission (2001) Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan.

Table 5.16 Calculation of accumulated internal accrual under the proposed corporate tax regime

Financial Year :	2004-05
Capital Cost	100
Interest Rate Applied(current Year)	8%
Depreciation	15%
Corporate Tax Rate	30.00%
Inflation (Capital Goods)(Preceding Year)	3.00%
Number of years over which CENVAT Credit is spread out	1
Number of years over which State VAT Credit is spread out	0

Amount in Rs.

Year	Asset value at the beginning of the year	CENVAT	State VAT	Depreciation (Declining Balance)				Interest	Tax on Interest	Interest Net of Tax	Balance in the Depreciation fund at the end of the year	Residual value at the end of the year	Accumulated internal accruals at the end of the year	Replacement value of Machinery
				Cost	CENVAT Credit	State VAT credit	Total							
1	78.37	12.54	9.09	11.76	12.54	1.36	25.66	0.00	0.00	0.00	25.66	74.34	100.00	100.00
2	66.61	0.00	7.73	9.99	0.00	1.16	11.15	2.05	0.62	1.44	38.25	63.19	101.44	103.00
3	56.62	0.00	6.57	8.49	0.00	0.99	9.48	3.06	0.92	2.44	50.17	53.71	103.88	106.09
4	48.13	0.00	5.58	7.22	0.00	0.84	8.06	4.01	1.20	3.40	61.62	45.65	107.28	109.27
5	40.91	0.00	4.75	6.14	0.00	0.71	6.85	4.93	1.48	4.31	72.79	38.81	111.59	112.55
6	34.77	0.00	4.03	5.22	0.00	0.60	5.82	5.82	1.75	5.21	83.81	32.99	116.80	115.93
7	29.56	0.00	3.43	4.43	0.00	0.51	4.95	6.71	2.01	6.09	94.85	28.04	122.89	119.41
8	25.12	0.00	2.91	3.77	0.00	0.44	4.21	7.59	2.28	6.97	106.03	23.83	129.86	122.99
9	21.36	0.00	2.48	3.20	0.00	0.37	3.57	8.48	2.54	7.87	117.47	20.26	137.73	126.68
10	18.15	0.00	2.11	2.72	0.00	0.32	3.04	9.40	2.82	8.78	129.29	17.22	146.51	130.48
11	15.43	0.00	1.79	2.31	0.00	0.27	2.58	10.34	3.10	9.73	141.60	14.64	156.24	134.39
12	13.11	0.00	1.52	1.97	0.00	0.23	2.20	11.33	3.40	10.71	154.51	12.44	166.95	138.42
13	11.15	0.00	1.29	1.67	0.00	0.19	1.87	12.36	3.71	11.74	168.12	10.57	178.69	142.58
14	9.48	0.00	1.10	1.42	0.00	0.16	1.59	13.45	4.03	12.83	182.54	8.99	191.53	146.85
15	8.05	0.00	0.93	1.21	0.00	0.14	1.35	14.60	4.38	13.99	197.88	7.64	205.52	151.26

3. Further, most of the eligible businesses are regulated and therefore assured of a fixed rate of return. The fixation of tariffs in such cases renders tax payable to be a pass through. Thus the incidence of income tax does not adversely affect the profitability and the NPV of the project for the investors.

4. Further, the exemption for certain types of businesses is in respect of partial profits. Since, these provisions were introduced when the tax rate was 40.25 per cent (35 per cent plus 15 per cent surcharge), the substantial benefit flowing from the proposed reduction in the tax rate to 30 per cent and exemption of dividends and long-term capital gains on equity, would adequately compensate for the loss from withdrawal of benefit u/s 80IA and 80IB.

Therefore, the incentives u/s 80IA and 80IB are not the first best solution to the problem. Such benefits do not protect the shareholders; the dividends distributed from exempt profit are taxable along with long-term capital gains. Further, these have also been a source of both abuse and large number of litigation increasing transaction costs all around. At best these incentives serve to camouflage the inadequate performance of the corporate managers. In view of the above, we recommend the phasing out of the provisions of section 80IA and 80IB over a period of two years. In the past, corporates have opposed the phasing out of these incentives on the ground of promissory estoppal. This objection is neither valid in law or in a dynamic environment characterised by steady liberalisation of tax structure and rules. Without prejudice to our recommendation to phase out the incentives, alternatively the government may consider grandfathering these incentives.

5.6.4 Treatment of corporate tax losses

A large number of countries permit businesses that earn a tax loss in one year (where taxable revenues are less than tax deductions in the same year) to carry the tax loss (i.e., the negative amount of taxable income) forward to future years, or (in a more limited number of cases) back to previous years, to be used to offset income in those years. The carry-back and carry-forward provisions are typically limited (e.g., a 3 year carry-back and a seven year carry-forward). These provisions are provided in recognition of the arbitrary choice of a fixed period (e.g., 12 months) for which to assess tax. The practice recognises that many companies/firms encounter negative cash flows during their initial phases, despite being profitable over the longer term or on a present value basis. Moreover, in certain high-risk industries, even very efficient and profitable firms may experience wide fluctuations in their earnings over both negative and positive ranges. Disallowing loss transfers over time would be inconsistent with a proper matching of revenues and expenses, would impose a higher tax burden on firms with unstable profit profiles, and would discourage risk-taking.

Conceptually, tax losses can be subdivided into three categories: i) operating business losses, ii) capital losses, and iii) tax incentive losses. Under the Indian income tax system, typically capital losses arising from depreciation are allowed to be carried forward indefinitely however the operating business losses representing revenue losses are allowed to be carried forward only for a period of eight years. This discourages projects with long gestation period as well as those which incur losses in the initial years of their operations. With a view to eliminating this bias, we recommend the removal of distinction between unabsorbed depreciation and unabsorbed business loss. In other words unabsorbed depreciation would be merged with business loss and loose its separate identity. Further, business loss would be allowed to be carried forward indefinitely. This will impart considerable administrative simplicity since it would not be necessary to maintain year wise breakup of the brought forward losses to determine the set off priority.[45]

5.6.5 Implementation strategy

The strategy for successful implementation of corporate tax reforms should be to implement the various recommendations on corporate tax as a package rather then independently. Therefore, we have designed two alternate sets of policy measures on corporate tax reform.

Option I

1. The corporate tax rate should be reduced from the existing level of 35.875 per cent to 30 per cent for domestic companies and to 35 per cent for foreign companies.
2. Exemption of long-term capital gains on equity to continue.
3. The tax on distribution of dividend by a company to continue at the existing rate of 12.5 per cent.
4. Eliminate the existing surcharge of 2.5 per cent.
5. The distinction between unabsorbed depreciation and unabsorbed business loss should be removed and business loss, like unabsorbed depreciation, should be allowed to carry forward indefinately.
6. The incentives under sections 10A, 10B, 80IA, 80IB, 80JJA, 80JJAA, 33AB, 33AC, 33B, 35AC, and 35CCA should be grandfathered i.e. The incentives would continue for the existing units/businesses which have commenced operation before 1st September, 2004 but would not be available to any new unit or business which commences operation on or after 1st September, 2004.
7. Depreciation rates for the purposes of deprec allowance under section 32 should be reduced to 15 percent for the general category of plant and machinery and to appropriate lower rates for other categories of block of assets. The revised rates of depreciation will, overtime, reduce the divergence between the depreciation charged to the profit and loss account in accordance with the provisions of the Companies Act and depreciation claimed for tax purposes.
8. No fresh tax incentives should be granted.
9. No tax incentives should be revived or sunset clause extended.

Option II

1. The corporate tax rate should be reduced from the existing level of 35.875 per cent to 30 per cent for domestic companies and to 35 per cent for foreign companies.
2. Exemption of long-term capital gains on equity to continue.
3. Dividend income will be exempt from income tax in the hands of the shareholder. Further, the tax on distribution of dividend by a company should also be eliminated.
4. Eliminate the existing surcharge of 2.5 per cent.
5. The distinction between unabsorbed depreciation and unabsorbed business loss should be removed and business loss, like unabsorbed depreciation, should be allowed to carry forward indefinitely.

[45] A large number of revenue audit objections every year relate to incorrect set off of losses.

6. The incentives under sections 10A, 10B, 80IA, 80IB, 80JJA, 80JJAA, 33AB, 33AC, 33B, 35AC, and 35CCA should be phased out over a period of next two years.

7. Depreciation rates for the purposes of deprec allowance under section 32 should be reduced to 15 percent for the general category of plant and machinery and to appropriate lower rates for other categories of block of assets. The revised rates of depreciation will, overtime, reduce the divergence between the depreciation charged to the profit and loss account in accordance with the provisions of the Companies Act and depreciation claimed for tax purposes.

8. No fresh tax incentives should be granted.

9. No tax incentives should be revived or sunset clause extended.

5.7 Strengthening tax administration

Tax administration is deeply intertwined with tax policy. Sound ideas in tax policy can flounder if they are poorly implemented. Conversely, new ideas in employing computer technology in tax administration now make it possible to engage in relatively complex kinds of information tracking and information manipulation, which are required in order to implement many key ideas of sound tax policy.

Compliance is strongly influenced by tax administration. A tax system that imposes high compliance costs innately produces incentives for individuals and firms to avoid interactions with the tax authority, and thus fosters the black economy. The resources expended in compliance are a deadweight cost for the economy, which are diverted away from producing other goods and services.

For these reasons, in recent years, there has been a strong accent on improving tax administration by building modern IT-intensive systems, which reduce human interfaces between taxpayers and the tax authorities, and reduce discretion.

It is useful to classify the overall problem of tax administration into two parts: *Normal operational procedures* and *Risk-based assessment*. Under normal operational procedures, there are three sub-systems:

1. The first is the self-reporting process whereby taxpayers file their own returns.

2. The second is 'third party reporting', where additional information about transactions and TDS is collected.

3. The third is the operational processes of tax payment, including reconcilation of funds.

In the area of customs, Electronic Data Interchange (EDI) procedures are used worldwide, and India has worked towards adoption of international standards. Through this, online filing and processing of customs documents is now operational at 25 customs stations in India. These stations now handle 75 per cent of the country's international trade, and handle roughly 3.5 million documents annually. In contrast, international standards do not directly drive modernisation of administration for excise and income tax.

5.7.1 The tax information network (TIN)

A significant part of direct taxes is collected at the source of income by mandating that parties paying for specified services have to deduct tax at source (TDS), and deposit the same to government accounts through a select list of banks branches. Currently this forms as much as 40% of the total direct tax collected.

The Income Tax Department (ITD) currently monitors the TDS by mandating deductors to file a consolidated return giving deductee wise details along with bank payment challan as proof of payment. The deductees claim credit for the TDS in their tax computation with TDS certificates provided by the deductor as supporting evidence.

The absence of a centralised database of these deduction and payment details led to many problems:

- Difficulty in verifying whether the deduction as per the TDS return filed has indeed been deposited to the account of the government.
- Difficulty in verifying whether the credits claimed by the deductee is based on real deduction and deposit to the account of the government.
- Possible harassment of genuine taxpayers.
- Some unscrupulous deductees claiming credits against fake certificates.
- In case of taxes other than TDS (advance tax, self assessment tax etc) the assessing officer has to rely purely on the copies of bank payment challans to verify whether the tax has actually been deposited.
- Deductees have no means to verify whether tax deducted on their behalf has been accounted in their name in the IT books.

In order to address these problems, CBDT embarked on the establishment of a system named Tax Information Network (TIN). This network was envisaged to integrate primary information of tax payments made in designated banks, tax deduction at source and information on high value transactions.

TIN thus receives on behalf of the tax administration, all TDS returns and other information for digitisation into a central database. TIN receives online information on collection of taxes from the banks through 'Online Tax Accounting System", which also flows into the central database.

TIN matches TDS returns from the deductors with the collection details from the banks and returns not matched by corresponding deposits are filtered out. Further, on the basis of this matched data a PAN wise electronic ledger account is prepared with the details tax credits posted into it.

Such a central system ensures that tax credits are allowed only against actual funds receipts to government coffers. The taxpayers also have the facility of accessing the TIN system to ascertain tax payments (made by them or deducted on their behalf).

The digitized information is downloaded to the National Computer Center of the ITD enabling faster processing of returns and refunds and data mining tools for non-intrusive investigation.

The Income Tax Department (ITD) has entrusted development, hosting and operation of TIN system to National Securities Depository Limited (NSDL). NSDL has established a strong infrastructural foundation in the last six months since TIN was inaugurated. These include the following.

- A central computing infrastructure to host the TIN database.
- A nationwide network of points of presence termed TIN - Facilitation Centres (TIN-FC) to interface with taxpayers and deductors to collect the returns and other information. Currently there are 403 such TIN-FCs in 148 cities and towns. This network is expected to extend to many more locations in the country. Earlier TDS returns could be filed in only 107

cities and towns.

- A large pool of trained manpower servicing taxpayers and deductors through TIN-FC.
- An internet portal hosting variety of TIN related information and support utilities.
- Online connectivity to collecting banks through OLTAS for online receipt of tax collection details.
- A web based facility for the taxpayers and collecting banks to inquire the status of their tax payments.

The overall goals of TIN are being implemented in phases. Phase I involves receipt of digitised TDS returns, digitisation of paper TDS Returns, receiving and storing data relating to tax collections coming from banks through OLTAS.

ITD has made it mandatory for all corporate deductors to file their e-TDS return in electronic form through TIN-FCs established by NSDL. Thus from this assessment year the total TDS records will be available in the TIN central database. NSDL is also facilitating digitization of TDS return being filed in physical form with the TIN-FCs to facilitate the entities not having the wherewithal to digitise. This has resulted in a huge saving for corporates which had to file loads of paper by way of TDS returns. From June 2004 banks have commenced uploading tax collection data in to TIN through OLTAS.

Phase II involves dematerialization of TDS Certificates. This will entail data upload by deductors on an ongoing basis to TIN and matching this with bank challans and subsequent posting of PAN level data to an electronic account of each PAN. This system is expected to be operational from April 1, 2005. Thus each PAN holder can have a single comprehensive statement depicting his total tax to his credit - paid by him and deducted on his behalf by other entities. The need to obtain TDS certificates from multiple agencies and preserving those certificates will be eliminated.

NSDL and ITD are also working towards enhancing the scope of TIN by facilitating tracking and PAN wise accounting of high value transactions etc through TIN.

In addition to TIN, CBDT has undertaken steps to outsource part of the process relating to receipt of PAN applications and printing / dispatch of PAN cards, to UTI Investors Services Ltd. from July 2003. Subsequently, the same services have also been outsourced to National Securities Depository Limited (NSDL) from June 2004. Facilities relating to handling of grievances in respect of PAN applications and tracking status of PAN applications have also been introduced from June 2004. It is proposed to provide additional services relating to e-filing of PAN applications from July 2004. In 2003-04, over 4.46 million PAN numbers were allotted. The total number of PAN allotted up to May 31, 2004 was 32.2 million.

The department has provided free software relating to online preparation of returns of income by taxpayers not having business income. The software is available through the web as well as on CDs. A pilot scheme for electronic filing of returns was introduced in financial year 2003-04. It has now proposed to further enchance the scheme for the current financial year.

A key area of special effort has been *faster processing of returns and issue of refunds*. A decision was taken to process all returns on computers, and to complete the processing of returns within 4 months of filing of the return. In 2003-04, 2.04 crore returns of income were processed. Over 95% of total processing work was done on computers. As a result, 5.166 million refund vouchers were issued for an amount of Rs.25,836 crore during financial year 2003-04. Improved processing of refunds has generated a sharp uptrend in the number and value of refunds issued: from Rs.17,300 crore (2.7 million vouchers) in 2001-02, to Rs.25,836 crore (5.7 million vouchers) in 2003-04.

OLTAS went live on 1 June 2004. Electronic filing of income-tax returns is likely to be operational by August 2004. Consolidation of regional databases, and commissioning of the national data centre, using a nationwide network, is likely to be in place by December 2004.

5.7.2 Proposals on improving 'normal operational procedures'

Implementation of GST The basic transaction flow of TIN is relevant in many situations other than that of CBDT. For example, in any implementation of a VAT, there needs to be a verification mechanism about the tax credits that are claimed at any stage. Every credit claimed should be legitimate, and no credit should be claimed twice. Sound databases and IT systems should support extensive tracking, and creation of summary reports and statistics, about all tax payments.

This is exactly the same as the situation faced by CBDT with TDS. Hence, the architecture and framework of TIN can be readily extended to CBEC for the purpose of implementation of the Goods and Services Tax (GST).

This is particularly important in the context of exports. When exports of either goods or services leave the country, they are entitled to obtain a refund of the GST embedded in them. This needs to be implemented using a state of the art IT system, so as to not impose transactions costs on exporters. In advanced countries, travellers leaving the country obtain refunds for the VAT payments embedded in the shopping that they may have done while in the country. Such systems need to come about in India, backed by sound IT systems so as to avoid fraud.

Unification of tax interfaces faced by the firm The firms of India have dealings with CBDT, CBEC and State level tax authorities. This amplifies compliance costs. These compliance costs are regressive, in that they impose the highest burden on the smallest firms.

An endeavour must come about to unify their tax interactions with the Government of India through a single IT system. The goal should be to present firms with a *single* IT system through which all direct tax and indirect tax compliance activities are undertaken. The accountant working within the firm should interact with a single IT interface for the purpose of achieving compliance with all these tax compliance purposes.

This would reduce compliance costs for the taxpayer, and avoid the duplication of systems that may otherwise be done by multiple tax authorities.

In achieving this integration, a key requirement is the *use of a single key, the PAN*. The taxpayer - whether an individual or a firm - should have single identification number, the PAN. This should serve as the single 'key' into the databases at CBDT or CBEC. A taxpayer who interacts with TIN should use his PAN as the single identity number, and get comprehensive statements about his own interaction with the tax system.

This recommendation dovetails well with a greater coordination between the introduction of GST at the Centre and the States. If the policy framework for the GST of the Centre and that of the State VAT are tightly integrated, then it will be possible to exhibit a single interface to the firms of India, and thereby reduce costs of compliance.

This integration of databases and unification of keys serves to set the stage for the transformation of enforcement, as discussed next.

5.7.3 Risk based assessment

Tax administration in India is increasingly moving towards a system that relies upon self-assessment of returns, and only selective scrutiny of these by the authorities. While the merits of such a system are well understood, there is obviously a concurrent rise in the risks of revenue leakage. It is thus necessary to develop non-intrusive, IT-based systems that can help in identifying non-compliance by screening large databases.

There is undoubtedly a need for risk-based assessment for both individuals and for firms. *The Committee recommends that the first priority should be given to building risk-based assessment systems covering firms*, for three reasons:

1. The number of entities dealt with is smaller. Roughly 100,000 firms would account for almost all GST and corporate income tax. This is hence an easier situation where new systems can be developed and proven, as compared with dealing with millions of individual taxpayers.

2. In the case of firms, there are clear opportunities to bring in powerful public-domain firm-level databases, which augment information available with the tax authorities, and thus engage in sophisticated information processing. Comparable databases about *individuals* do not exist.

3. The poor buoyancy of excise collections is a glaring lacuna in Indian public finance, which needs to be urgently addressed. In contrast, personal income tax buoyancy has been fairly strong, and there is not a comparable urgency of seeking to rapidly improve the buoyancy.

We hence focus on the problem of risk-based assessment of firms, and thus primarily on customs, excise and corporate income tax. Broadly, there are three major components of developing systems that can help the government in containing the risk of revenue leaks when it comes to firms:

1. First, is the need to build a comprehensive database of the huge amounts of information that about the firms of India.

2. These databases should be subjected to statistical analysis to develop the predictive systems that can identify the characteristics of firms where tax revenues are unusually small. When faced with a sufficiently strong range of information about the firm, non-compliance innately introduces inconsistencies which can be detected.

   The development of these predictive systems would exploit tools in machine learning and econometrics, combining data analysis and domain knowledge.

3. Finally, we need an efficient technological mechanism to deliver this information and this ‘expertise’, embedded in a IT system, across the entire spectrum of the tax administration system.

The Committee proposes the creation of a system named *Risk Intelligence Network* (RIN) which would perform these functions. This is the logical next milestone for tax administration in the country, after the success of TIN. RIN would harness the databases which are being created by TIN, it would closely interoperate with TIN, and would give a quantum leap in tax compliance in the country. It is important to note that TIN and RIN should be integrated systems which work for both CBEC and CBDT.

5.7.4 Risk intelligence network (RIN)

Intuitively, the idea of RIN works as follows. For every firm, we would have access four kinds of information: Corporate income tax transactions and filings, GST transactions and filings, Customs transactions and filings, and *public domain databases about the firm*.

The first three elements of this would come about when TIN is fully implemented across corporate income tax, excise and customs. The last database consists of a great deal of information is being released by firms into the public domain, to shareholders, regulators, etc., which needs to be obtained and integrated into RIN.

RIN would examine information about each firm, in these four databases, and look for inconsistencies. For example, consider a firm which imports rubber, makes tyres, but engages in illegal removal of tyres from the factory in order to evade excise, and in order to cheat shareholders. This firm would look unusual when analysing the four databases, as follows. It would seem to be buying a lot of raw materials (as shown in the annual report shown to the shareholders, and as shown in the payment of customs on imported rubber). However, as compared with other firms in the industry, it would be generating unusually small profits, unusually small GST payments, and unusually small corporate income tax payments. If the extent of these deviations from normal patterns is statistically significant, then this firm would be picked up by RIN for scrutiny.

It is important to emphasise that such opportunities for detecting inconsistencies can *only* come about if there is an integration between information of CBDT and CBEC. A fragmented approach to the firm - where risk assessment is done separately by income tax as opposed to customs - would not catch the most important inconsistencies thrown up by tax evaders. Hence, it is recommended that both TIN and RIN should be shared facilities used by both CBDT and CBEC.

The database

There is a need for one single fully integrated database containing a broad gamut of public-domain information covering all firms operating in India. Several arms of the government, including regulators, are collecting information from firms or requiring disclosure by firms. Information is being disclosed by firms to shareholders, to regulators, and to financial markets. The form, content, periodicity, etc differ vastly from one agency to another. Redundancy is rampant and, coordination of the databases is nonexistent.

All these databases need to be *normalised* and *integrated* into one. Normalisation is the process of recasting the values so as to maximise inter-year and inter-firm comparability of the data. Integration is the process of building efficient links across different types of data. This would involve a massive 'relational database management system' to house the database, and a specially developed set of tools to access this database and move on to construction and operation of expert systems.

There are tremendous gains in the concept of a single integrated and normalised database that holds all the information on all companies in one place. With such a database, a great deal of information that is presently being produced for the purpose of meeting the needs of shareholders, regulators, registrars, media, etc can become immediately available to tax authorities without needing to devise new and costly ways for obtaining information.

Expert systems for risk-based assessment

The TIN database and the RIN database would provide a rich repository of information – including financial performance and returns filed with the various tax authorities. This information would be easily accessible, and conveniently delivered using a web browser to the desktop of authorised staff in the tax administration.

The integrated and normalised database would form an excellent 'mine' of information from which, inferences can be drawn by using sophisticated analytical tools. Such a database would contain historical observations of individual firms that could be sliced by size, industry and other characteristics. Such classifications would be used in developing set-specific (such as industry, size, etc.) models to predict the identity of firms that merit closer examination by the tax authorities.

These econometric models would help the government in undertaking risk based assessments. The models would produce results based on historical and structural patterns. It would identify the outliers to the larger conforming set of firms.

The model parameters need to be re-estimated regularly, so as to incorporate the latest information available in the database.

All alerts thrown up by the models would be tracked till their final disposition. Some alerts would be correct, but some alerts would be inevitably mistaken. This information would be fed back into refining the models on an ongoing basis. This refinement of models is assisted if there is an incidence of both Type 1 and Type 2 errors.[46] Hence, alerts from models would be augmented by a small flow of purely random cases chosen for scrutiny, in order to create an ongoing MIS on the incidence of Type 2 errors, and to feed this information back into refinement of models.

Delivery and training

Sophisticated technology needs to be brought to bear on the efficient delivery of all the information contained in the database and the model to the entire tax administration staff. This is best done by ensuring that the database is available on a continuous basis, using Internet technology, to the tax authorities.

An officer should be able to go to a web browser, enter the PAN of a firm, and retrieve a range of well organised information. He should be able to look at a firm over time. He should be able to compare a firm with its peers – similar sized firms in the same industry. He should be able to notice that while there are 50 firms of a similar size in the cement industry, this firm seems to show an unusually low ratio of sales as percent of raw material purchases.

Delivery of pure information should blend in a continuum with delivery of analytical models. This same software system should deliver access to models that identify "outliers" that can trigger risk-based assessment.

The emphasis on Internet technologies would avoid a lock-in to proprietary technology, and inter-operate well with the IT initiatives of the tax administration such as TIN. Access

[46] A Type 1 error is one where a taxpayer is honest, but is falsely identified as having unusual patterns by RIN. A Type 2 error is one where a dishonest taxpayer appears to have 'normal' patterns of behaviour and is not picked up by RIN.

through the Internet would ensure that there are no effective geographical boundaries. All desktops in CBDT and CBEC should be equipped with this system, which should become the backbone of the future of tax administration.

Staff of CBDT and CBEC would need extensive and regular training in utilising this system. It is important to appreciate that the training would be very focused towards using this browser-delivered system for accessing databases and towards understanding and using the analytical tools. This training should *not* be mixed with general education on databases or database management systems or mining tools in general. It is important that the administration is imparted technical training to use the specific databases and analytical tools as such a training would deliver maximum returns. The above system, combining information and analytics, should be the visible foundation of the training program.

5.8 Non-tax revenues

In the reforms scenario, the telecom industry would be brought under the GST like any other business. In this case, the existing license fees, which are based on revenue sharing, would be abolished. This would show up as GST revenues, and non-tax revenues would be lower. In 2004-05 BE, the non-tax revenues from the telecom industry amount to Rs.6,044 crore.

One area where the exchequer may be able to derive considerable fresh non-tax revenues is in the area of spectrum receipts. The electromagnetic spectrum is a scarce resource. The State performs allocative functions for this resource, and can derive non-tax revenue from this. One format could be to auction ten-year licenses for pieces of the electromagnetic spectrum.

At present, spectrum fees are at a level of Rs.650 crore to Rs.700 crore per annum. In countries like the United Kingdom, Germany, Singapore, etc., spectrum auctions have been utilised as a market-based mechanism for maximising the economic efficiency of utilisation of spectrum. As an example, in the US, in the period from July 1994 to February 2001, the Federal Communications Commission (FCC) conducted 33 spectrum auctions, raising over $40 billion for the US Treasury. Very large auction proceeds were also obtained in Europe.

The Task Force recommends that the Ministry of Finance should work with TRAI in the creation of a working group to explore these issues, and possibly identify mechanisms through which the spectrum can be efficiently auctioned to telecom and computer industry service providers, so as to augment non-tax revenues for the government. At the same time, this approach should not preclude the use of subsets of the electromagnetic spectrum as 'public goods' through protocols like 802.11.

5.9 Expenditure reforms

Despite expenses by the central government of Rs.477,829 crore in 2004-05 (BE), and further expenses by state and local governments, the provision of public goods in the country continues to lag in terms of both quality and quantity. The ultimate goal of expenditure reforms lies in refocusing expenditure on public goods, and improving the instrumentalities used to translate a resource outflow into public goods *outcomes*. On June 24, 2004, the Prime Minister's address to the nation eloquently set out the ultimate goals of expenditure reform:

> *However, I am convinced that the government, at every level, is today not adequately equipped and attuned to deal with this challenge and meet the aspirations of the people. To be able to do so, we require the reform of government and of public institutions...*
>
> *"We will pursue economic reform and widen the space for individual initiative and enterprise, but even as we do so, we cannot forsake the obligation of running a government that works, and works for the people. The reform of administration and of public institutions to improve efficiency and the quality of delivery services will be our immediate priority.*
>
> *"No objective in this development agenda can be met if we do not reform the instrument in our hand with which we have to work, namely the government and public institutions. Clearly, this will be my main concern and challenge in the days to come."*

The total expenditure in 2004-05 (BE) of Rs.477,829 crore is comprised of Rs.385,493 crore and Rs.92,335 crore of capital expenditure. Using the second classification, it can also be expressed as Rs.145,590 crore of 'plan expenditure' and the residual Rs.332,239 crore of 'non-plan expenditure'.

Non-plan expenditure includes relatively less flexible expenditure on items like interest, subsidies, defence, salaries, pension etc. It is thus inherently more difficult to obtain expenditure compression on non-plan expenditure. The exception to this is interest payments, which are likely to decline through a combination of (a) Declining average interest cost and (b) Fiscal consolidation.

This report has argued that the central feature of India's fiscal consolidation should be an improvement of the tax-GDP ratio. At the same time, there is considerable concern about the quality of public expenditure in India.

The public's willingness to pay taxes, and to fully bear user charges, is shaped by the quality of public goods and infrastructural services which are delivered to the public. This behavioural link implies that there is a link between improving the effectiveness of expenditure and improving tax collections and user charges.

If the production of public goods is improved, this would have a powerful and positive impact on GDP growth. In recent years, improvements in telecom, roads and ports have generated a manifestly visible impact upon productivity of individuals and firms. Similarly, improvements in other public goods, ranging across the justice system, property records, public health, primary education, etc. would all have a positive impact on India's GDP growth. This would improve India's debt dynamics and help address the fiscal problem.

The broad strategy for expenditure reforms may be summarised as comprising of four elements:

I. Public goods versus subsidies A greater portion of expenditure needs to be devoted to legitimate public goods, as opposed to transfers and subsidies. The plan versus non-plan or the capital versus revenue classifications need to be re-examined in this light.

II. Central versus local public goods In the spirit of the 74th amendment, resources that are used for the production of local public goods, such as water, sanitation, and primary education, should be transferred to Panchayati Raj institutions, who have better *incentive* to spend effectively, and have better *knowledge* about local preferences, local problems, and alternative production technologies.

III. Focus on public goods outcomes The public finance system in India has traditionally focused on *expenditure*. There is a need for a greater focus on public goods *outcomes*.

IV. Improvements in institutional mechanisms The *provision* of public goods can often be achieved more effectively through the use of the private sector in production. The role of public-private partnerships needs to be extended into a broader range of public goods.

5.9.1 Public goods versus subsidies

The current practice of categorizing expenditure as Plan and Non-Plan has outlived its utility and needs to be reviewed. The plan versus non-plan distinction ignores the demarcation between capital expenditure versus current expenditure. More importantly, it is silent on the distinction between expenditure programs which produce public goods versus those which do not.[47]

Internationally the normal practice is to distinguish between capital and current expenditure. In addition, some OECD reports use a three-way classification:

1. Defence,
2. Subsidies,
3. Public goods.

There is a need to improve the classification of expenditure in two directions:

1. The breakdown by capital versus current expenditure needs to be closely reviewed, so as to remove existing mistakes in classification, and
2. An extensive effort is required, in close consultation with the Planning Commission, to move away from the 'plan versus non-plan' classification, and shift instead to a 'subsidies versus public goods' classification.

There is a considerable consensus that the existing food and fertiliser subsidy programs are ineffective at reaching the poor. The food, fertilizer and petroleum subsidies may hence be reviewed in order to obtain more efficient and cost effective administration, which deliver a bigger fraction of the budgetary cost to the poor. Major improvements in the functioning of the Food Corporation of India (FCI) to control inefficiencies will reduce the food subsidy, which was as large as Rs.25,204 crore in 2003-04 (RE).

The subsidy on LPG / Kerosene (Rs.6292 crores in RE 2003-04) was scheduled to have been reduced by one-third each year beginning 2003-04. As such, no subsidy is planned for LPG/SKO from 2005-06.[48] This is expected to lead to reduced expenditure to the extent of the existing outgo on the LPG / SKO subsidy.

5.9.2 Central versus local public goods

Some public goods, like financial regulation, national defence, or monetary policy are effectively produced at the Centre. In

[47] Public goods are defined as those which are 'non-rival' and 'non-excludable'. *Non-rival* denotes the fact that one person's consumption does not reduce the quantity available to others. *Non-excludable* denotes the fact that it is not possible to prevent any citizen of the country from enjoying the consumption of the public good. Law and order is an example of a public good.

[48] This does not take into account the under-recoveries by the Oil CPSUs', which are in the region of Rs.9000 crores.

contrast, many public goods are local in nature. Examples of these include health, primary education, water and sewage, and local roads. Weaknesses in all these areas are important problems which are holding back GDP growth.

The 74th amendment to the constitution was motivated by this aspect. The spirit of this amendment consists of devolution of resources for the production of local public goods down to local government. This procedure would require a considerable re-engineering of expenditure, as compared with the present framework of centrally controlled expenditures under Centrally Sponsored Schemes (CSS).

Local governments are better equipped to produce local public goods for several reasons. Local governments can be better attuned to *local tastes and preferences*. Local governments can better respond to local problems, and allocate resources to the most important issues, such as the water problem in Chennai. Local governments can make better decisions about the technologies and contractual structures which can deliver sound outcomes. Local governments have more direct accountability to local voters for local performance.

These arguments suggest that expenditures on public goods need to be reviewed, distinguishing central public goods from local public goods. Better institutional frameworks need to be created to foster governance capacity in local government, to deliver resources used for producing local public goods to local governments, with appropriate checks and balances to give incentives for reform, and to improve the efficiency with which government expenditures turn into public goods outcomes.

These issues can be addressed as part of the proposed Administrative Reforms Commission.

5.9.3 Focus on public goods outcomes

A central theme in expenditure reforms is to shift focus from expenditures to outcomes. The number of children vaccinated is more important than the money spent on a vaccination program.

One key part of this will be about the role of the CAG. It is possible to envision a framework where the documentation of each scheme of the Government of India specifically defines the expected outcomes in numerical terms. It may be possible for the CAG to then go beyond the existing functions, which are focused on expenditure, and do a performance audit, which tests the extent to which a scheme actually delivered on the promised goals in terms of *outcomes*.

The statistical system, and the information dissemination from government departments, would need to correspondingly improve the information released on public goods outcomes, and on the impact of each scheme. This would improve the quality of public analysis and debate about the *effectiveness* of various alternative mechanisms for improving the provision of public goods.

5.9.4 Achieving better public goods outcomes

Consolidation of centrally sponsored schemes

Through a zero-based budgeting exercise conducted by the Planning Commission, the number of Centrally Sponsored Schemes (CSS) was brought down from 316 in the 9th Plan to 188 in the 10th Plan. The number of

Central Sector schemes was brought down from 2247 to 922. At the same time, the number of schemes remains very large and new schemes are continually being initiated. There are 23 CSS and 417 CS schemes which have a 10th Plan allocation of below Rs.20 crore.

This proliferation of schemes has inhibited the effectiveness of producing public goods. A full re-examination of every scheme needs to be undertaken, seeking to (a) Consolidate schemes into operationally manageable units, (b) Refocus expenditures upon the provision of public goods, and (c) Seek innovative production mechanisms through which public expenditures can deliver the maximum value for money in terms of public goods provided per unit expenditure.

Reform-linked transfers One of the most powerful instruments for achieving better expenditure management is reform-linked funds. There is a need to shift resources from the existing centrally-driven spending programs to a framework where transfers are made to Panchayati Raj institutions, contingent on sound reforms initiatives emerging from the lower levels of government. Several efforts of this nature have commenced, includeing the Fiscal Reforms Facility, the APDRP, the City Challenge Fund and the URIF.

A new fiscal framework needs to be evolved which carries these ideas further. This will innately require shifting resources away from the centrally-driven CSS framework, and close down mechanisms through which resource flows take place without sound institutional arrangements at the subnational government.

5.9.5 Incremental improvements in institutional mechanisms

In a framework where data on *expenditures* for the production of public goods is available, and where data on public goods *outcomes* is available, it will become possible to focus on questions of *efficiency*.

Expenditure reforms also aim at ensuring 'value for money' by making each rupee spent go farther, through improved productivity and quality of expenditure. At present, projects are often beset with time and cost over-runs, and programme implementation and delivery systems are also not very efficient. Service delivery and asset / manpower utilisation is poor. Financial management systems, especially in schemes implemented through the State Governments, are largely neglected, and frequently not capable of keeping track of the funds and ensuring their proper / timely utilisation. Monitoring and accountability is also often lacking.

Ensuring 'value for money' requires effective organisational, programme / project implementation and delivery systems, which are intrinsic elements of the Administrative Reforms process. The implementation of poverty alleviation and rural development schemes by Panchayats requires strong financial systems.

There is a need to move gradually from 'itemised' control of expenditure to 'budgetary' control of expenditure, with sophisticated exchequer control mechanisms, and effective implementation / delivery systems. This will require detailed and careful budgeting at the beginning of the year; significant delegation to administrative Ministries to operate within the approved budgets; well regulated cash flow; strong financial management systems at all levels; and organisational restructuring / process re-engineering to ensure 'value for money'.

A shift to 'budgetary' control of expenditure would also require appropriate capacity building and institutional arrangements within the administrative Ministries, for improved delivery and better realisation of 'value for money'. Increasingly more financial powers may be delegated to individual administrative Ministries, including to JSs / Secretaries, on demonstrating effective internal institutionalised arrangements to exercise these powers prudently and judiciously.

While government generally has a role to play in the *provision* of public goods, there may often be ways through which efficiency can be improved by shifting away from government *production* of public goods. The idea of public-private partnerships has been used with considerable success in some areas - primarily in infrastructure. There is a role for extending this idea into many other aspects of the production of public goods.

In terms of improved management of public finances, there are opportunities for engineering improvements in the financing patterns of government debt.

1. One element of this is a more extensive effort to buy back illiquid government bonds, and replace them by more liquid government bonds. Such an effort can save money to the extent of the 'liquidity premium' that is embedded in the prices of illiquid bonds. In addition, it can foster bond market liquidity, by fueling the growth in market size of the more liquid products. One transaction of this nature has been undertaken in the past. The cross-sectional distribution of liquidity amongst government bonds shows that roughly 100 of the bond issues are highly illiquid, which suggests that one or more profitable transactions of this nature could be undertaken in the future.

2. Another element of a reforms framework consists of substituting loans to states with market borrowings. Instead of the central government, giving loans to states, states can be allowed to enter the market for borrowing an equivalent amount directly. This would reduce central government capital expenditure and fiscal deficit, while reducing the cost of borrowing for the states.

3. An area which needs close attention is the salary component of Government expenditure. The finances of the Central government as well as State governments are still undergoing the deleterious effects of the 5th Central Pay Commission. A considerable scope to control wage expenditure remains, using: outsourcing of non-core functions, extensive use of IT, VRS, multi-skilling, retraining and gradual change in the composition of recruitment. A detailed action plan needs to be drawn up in order to address this goal.

Chapter 6

Fiscal projections under reforms scenario

In the earlier chapters we have emphasised that the fiscal correction during the adjustment period must necessarily be revenue driven, the policy initiatives must be front-loaded and have also indicated at length the package of policy measures which will enable the country to achieve the targets laid down in the Fiscal Responsibility and Budget Management Act, 2003.

The overall emphasis in designing the reform package is to establish a world-class non-distortionary, transparent and sustainable fiscal system which will inspire confidence in all stakeholders: both citizens and foreign investors and enable us to launch a frontal attack on impoverishment, illiteracy and morbidity.

In Section 3.3, it was argued that in the baseline scenario, GDP growth will be slower owing to the fiscal problems. Under the reforms scenario, the opposite effects come into play.

If the fiscal system is re-engineered in the fashion described in this report, there would be a two fold impact. First, India would put its fiscal house in order, achieve a declining Liabilities/GDP ratio, and inspire confidence in the eyes of domestic and foreign investors. Second, tax reforms would unleash the Indian economy, by removing tax-induced distortions which have resulted in inefficient organisation of production.

Table 6.1 GDP at market prices under reforms scenario

(Rs. crore)

Year	GDP	Growth (%)
2003-04	27,72,194	
2004-05	31,04,857	12.00
2005-06	34,77,440	12.00
2006-07	39,03,426	12.25
2007-08	43,91,354	12.50
2008-09	49,62,303	13.00

Table 6.1 shows projections for GDP under the reforms scenario. While nominal GDP growth was expected to slow down from 12 per cent per year in 2005-06 to 11.25 per cent per year in 2008-09 under the baseline scenario, GDP growth is instead expected to accelerate to 13 per cent per year in 2008-09 under the reforms scenario.

6.1 Rationale of projections under reforms scenario

In this section, we articulate the rationale of how the proposed reforms of the previous chapter will impact on various components of revenue and expenditure.

6.1.1 Personal income tax

The package of measures recommended for personal income tax focus on eliminating the bias against savings and altering the economics of compliance by further liberalising the personal tax rates through broad basing the tax slabs. While there would be revenue loss at existing levels of compliance, the same can be reasonably expected to increase during the adjustment period resulting in an improvement in the PIT-GDP ratio from 1.45 in 2003-04 to 2.26 in 2008-09. Further, these revenue outcomes will be achieved with greater progressivity and economic efficiency.

The proposals of this report in regard to personal income tax are projected to directly generate a revenue loss of Rs.11,243 crore at existing levels of compliance. However, cross-country experience and empirical research on taxpayer compliance behaviour in India suggest that compliance will be significantly improved when tax rates are reduced and tax laws are simplified and rationalised.

Given the typically skewed distribution of taxpayers, we could reasonably expect to recoup 60% of the revenue loss in the first year (2005-06) through improved compliance. In 2006-07, this is projected to increase to 110%, and grow further to 115% in 2007-08, and stay at that level thereafter.

Discussions with field-level tax officials show that the current initiatives for modernisation of tax administration, such as the TIN and other initiatives proposed in this report, will yield a substantial positive impact on compliance from 2005-06 onwards. We assume that this will give improvements in tax revenues, over and above all other issues, by a factor of of 2.5% in 2005-06, 5% in 2006-07, 7.5% in 2007-08 and 10% in 2008-09.

As Table 6.2 illustrates, ***all classes of taxpayers will benefit significantly from these proposals***. The estimates shown in this table are highly authoritative as they are based on an empirical analysis of around 1 million income tax returns spread over three years. These calculations are hence far more credible as compared with specific illustrations which are sometimes used in these debates.

The new savings incentive designed on a EET method will promote long-term savings and enhance the long term debt servicing capability of the Central Government. Similarly, the rationalisation of the tax treatment of zero-coupon bonds will provide the necessary finances for infrastructure and also increase bond supply in the debt market to fulfill the potential increase in demand for long term bonds in view of the rationalisation of savings incentives.

6.1.2 Corporation tax

The proposals of this report in regard to corporate tax are projected to directly generate a revenue gain of Rs.6,698 crore at existing levels of compliance. However, cross-country experience and empirical research on taxpayer compliance behaviour in India suggest that compliance will be significantly improved when tax rates are reduced and tax laws are simplified and rationalised.[1]

Discussions with field-level tax officials show that the current initiatives for moderni-

[1] See *Tax rates, tax compliance and tax revenues: India, 1988-2004*, Surjit Bhalla. This paper can be accessed at http://www.oxusresearch.com on the world wide web.

Table 6.2 Impact of proposed personal income tax reforms on individual taxpayers

This table shows the projected impact upon a typical taxpayer of the proposed personal income tax policy reforms, simulated on a randomly chosen dataset of roughly 1,000,000 taxpayers, using their income tax filings. In each income range, the averages of all records in this dataset are reported in the table. For example, the results show that for a salaried taxpayer with an income between Rs.100,000 and Rs.150,000, the proposed changes would yield a reduction in income tax payment of Rs.3,272.

	Salaried taxpayers			Non-salaried taxpayers		
Income range	Existing	Post-reform	Benefit	Existing	Post-reform	Benefit
0-40,000	Nil	Nil	Nil	Nil	Nil	Nil
40,000-50,000	Nil	Nil	Nil	Nil	Nil	Nil
50,000-60,000	Nil	Nil	Nil	382	Nil	+382
60,000-80,000	Nil	Nil	Nil	2,196	0	+2,196
80,000-1,00,000	1,638	406	+1,233	5,452	0	+5,452
1,00,000-1,50,000	8,941	5,669	+3,272	10,697	4,016	+6,681
1,50,000-2,00,000	22,915	14,696	+8,219	23,522	14,136	+9,386
2,00,000-3,00,000	43,370	27,708	+15,663	44,830	29,928	+14,903
3,00,000-4,00,000	75,705	46,975	+28,731	76,855	51,334	+25,521
4,00,000-5,00,000	106,652	69,831	+36,821	108,923	77,634	+31,289
5,00,000-10,00,000	185,731	134,648	+51,084	188,671	149,645	+39,026
Above 10,00,000	734,591	660,812	+73,779	1,177,511	1,088,594	+88,917

sation of tax administration, such as TIN, RIN and other initiatives proposed in this report, will yield a substantial positive impact on compliance from 2005-06 onwards. We assume that this will give improvements in tax revenues, over and above all other issues, by a factor of 3% in 2005-06, 6% in 2006-07, 8% in 2007-08 and 9% in 2008-09.

An empirical analysis of the proposed package of reforms relating to corporate tax, using the CMIE database, is shown in Table 6.3. This suggests that these reforms may be expected to increase the corporate tax-GDP ratio from 2.27 in 2003-04 to 4.20 in 2008-09. While the rate reductions while eliminate the differential in tax regime across forms of organisations, it will also reduce the marginal rates for small and medium enterprises.

Therefore, the ex-ante cost of equity capital will reduce and so will the weighted average cost of capital. As a result, investment decisions at the margin will become profitable.

Further, the reduction in depreciation rates will eliminate the bias against labour without adversely affecting the internal accruals for replacement and modernisation. To the extent credit for CENVAT on capital goods is also proposed to be allowed in the year of acquisition, this should further augment internal accruals. Investment in capital assets will be motivated by profitability and not driven by tax considerations. Entrepreneurs will now be motivated to improve efficiency in the use of capital assets.

Detailed calculations which take into account the revenue impact of the twin proposal - to reduce corporate tax rates and to reduce depreciation rates - are contained in Table 6.3. These are essentially static calculations, and do not reflect the most important aspects of the proposed reforms, which are the improved economic efficiency and administrative effectiveness. These revenue

Table 6.3 Estimates of revenue impact of proposed changes to corporate income tax rates and depreciation rates

This table shows the projected impact of the proposed corporate tax policy reforms, on corporate tax revenues, simulated using the 2,952 non-banking profit-makinng firms and the 65 profit-making banks observed in the CMIE Prowess dataset.

	Element	2952 profit-making non-banking firms	65 profit-making banks	Total
1	Profits before tax in 2002-03	109460	23150	132610
2	Tax paid at 2002-03 rate (36.75 per cent)	25245	7008	32253
3	Tax paid at 2003-04 rate (35.875 per cent)	24644	6841	31485
4	Taxable base	68694	19069	87763
5	Book depreciation as per CMIE database	41917	2682	44599
6	Deferred tax as per CMIE database	5628	192	5820
7	Excess of tax depreciation over book depreciation	15314	522	15837
8	Total tax depreciation	57231	3204	60436
9	WDV of assets	228925	12818	241743
10	Tax depreciation at 15 per cent	34339	1923	36261
11	Reduction in tax depreciation	22893	1282	4174
13	Taxable base before depreciation	125925	22274	148199
14	Adjusted taxable base	91586	20351	111938
15	Tax at 30 per cent	27476	6105	33581
16	Net gain in revenue from sample companies	2832	-736	2096
17	**Net gain in revenue (in per cent)**	**11.22**	**-10.50**	**8.5**
18	Gross corporate collection in 2003-04 (excluding regular collections)	62550	9000	71550
19	**Net increase in revenue**	**7017**	**-945**	**6072**

projections should therefore be considered conservative.

6.1.3 Union excise duties

In the earlier chapters we have pointed out the disappointingly low buoyancy, of 0.75, in the case of union excises in the baseline scenario. The proposed reduction in rates and the change in CENVAT credit system for capital goods will reduce revenues. However, this is projected to be overcome through base expansion to the retail stage, on account of comprehensive taxation of services.

We have also assumed an increase in revenues through improved compliance, owing to the modernisation of the tax administration, by a factor of 5% in 2005-06, 10% in 2006-07, 12.5% in 2007-08 and 15% in 2008-09.

The overall impact of these changes is projected to bring the buoyancy of excise up to 0.98, which would stabilise the excise tax to GDP ratio. This increase is modest in the light of the average buoyancy for central tax revenues.

The combined revenues from both union excises and service tax will therefore increase from 3.6 per cent of GDP in 2003-04 to 5.44 per cent of GDP by 2008-09. With a standard rate of 12 per cent, the GDP-efficiency of the proposed GST by the centre

Table 6.4 Projection of service tax revenues

Estimated revenues from 51,651 service sector firms with turnover above Rs.10 lakh, at 12% of gross value added less interest payments in 2002-03 (Table B.9)	26,035
Extrapolation of the above to 2003-04 by a factor of 10%	2,604
Estimated additional revenues from transport services not covered by CMIE dataset (assuming 90% coverage for Railways, 100% for Air, 50% for water transport and 50% for road transport)	8,670
Estimated additional revenues from construction services not covered by CMIE dataset (assuming 70% coverage)	12,987
Estimated additional revenues from urban dwelling services not covered by CMIE dataset (assuming 40% coverage)	3,859
Total	54,155
Less: existing service tax revenues	8,300
Additional revenues in 2003-04 from 12% service tax	45,855

is 0.45, which is consistent with international experience.[2] These revenue estimates from this source are therefore reasonable and achievable, particularly given the tremendous IT and telecommunications capacity found in India.

6.1.4 Service tax

Table 6.4 shows the rationale behind the projections for service tax, focusing on the potential revenues for 2003-04. This uses the results from Appendix B. Projections from 2003-04 till 2005-06 are made assuming a buoyancy of 1. The buoyancy is assumed to go up to 1.28, being the average buoyancy of central taxes under the baseline scenario. This reflects the broad-based improvements in tax reforms, simplification and administration. However, for the first year (2005-06), a more modest projection is made, which is 15% below these calculations, to account for the difficulties of first-time implementation.

Our recommendations to extend service tax to all services except a small negative list will remove the numerous distortions in the goods and services tax which we have alluded to earlier. The revenues from this undertaxed sector will grow from 0.45 per cent of GDP in 2004-05 to 2.14 per cent in 2008-09. The impact of integrating the service tax with the union excises on goods is extensively documented in the subsequent chapter.

6.1.5 Customs

Customs revenues are projected to decline from 1.78 per cent of GDP in 2003-04 to 1.03 per cent of GDP in 2008-09. These are comparable estimates, which show the sum of customs and CVD collections.

The decline is primarily on account of reduction in customs tariff rates, on the lines proposed in the previous chapter. The revenue loss on account of these rate reforms have been fully factored into the projections of this chapter.

[2]The average efficiency across countries is estimated to be 0.4. However, most countries with a modern VAT and tax administration have higher efficiency ratios.

Table 6.5 Additional resource mobilisation (ARM) by tax source

These incremental values (ARM) when added to the revenue projections under the baseline scenario, yield the revenue projections under the reforms scenario. In all cases, it is assumed that the full set of policy reforms proposed in this report are implemented in 2005-06, and that policies stay unchanged thereafter. The growth in all cases comes from normal trend behaviour, and incremental growth every year owing to improvements in tax administration and behavioural changes.

(Rs. crore, differences compared with baseline)

Tax	2005-06	2006-07	2007-08	2008-09
Personal income tax	-3,148	4,902	8,831	13,042
Corporate tax	9,773	15,884	22,668	29,696
Union excise duties	2,594	13,150	17,624	22,816
Service tax	44,890	61,650	72,190	85,082
Customs	-8,302	-13,697	-15,067	-16,574
Total	45,807	81,890	106,246	134,062

6.1.6 Summarising the impact of proposed reforms on all tax components

Table 6.5 summarises the projected numerical impact of all the policy proposals of this report on tax revenues, using the imputation strategies outlined above.

6.1.7 Summarising basis for projections for baseline and reforms scenarios

Tables 6.6 and 6.7 show, in tabular form, a comparison of the assumptions used in the baseline scenario and the comparable values used in the reforms scenario.

6.2 Major economic features of the reforms scenario

6.2.1 Tax projections for reforms scenario

Estimates of Central Government tax revenues by sources, in the post-reform scenario, are presented in terms of levels in Table 6.8. The buoyancy of gross tax collections, under these projections, works out to 1.65, and imply a 20.3 per cent per year average growth in gross tax collections. The highest growth is seen in service tax. Customs growth is projected to stagnate, given the reforms envisaged in terms of cutting tariffs. Excise buoyancy works out to 0.98 in the reforms scenario, as opposed to the sluggish performance of excise collections in the baseline scenario.

Tax projections, under the reforms scenario, are expressed as per cent to GDP in Table 6.9. Gross tax collections are projected to go up from 10.08 per cent of GDP in 2004-05 (BE) to 12.96 per cent of GDP in 2008-09, an increase of 2.88 percentage points.

As emphasised above, the trajectory of revenue gains has been defined under the assumption that the tax reforms are implemented at the start of 2005-06. While the proposed reforms are front-loaded, their impact is smeared over the years from 2005-06, 2006-07 and 2007-08. As emphasised in the earlier chapter, increases of a similar magnitude has been registered by many countries which have undertaken similar comprehensive tax reform. Therefore, even

Table 6.6 Revenue assumptions underlying baseline versus reforms scenarios

	Baseline	Reforms
GDP	Growth rate of 12 percent in 2004-05 and 2005-06, 11.75 percent in 2006-07, 11.5 percent in 2007-08 and 11.25 percent in 2008-09.	Growth rate of 12 percent in 2004-05 and 2005-06, 12.25 percent in 2006-07, 12.5 percent in 2007-08 and 13 percent in 2008-09.
Tax revenue		
Income tax	Estimated average buoyancy of 1.69	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 1.84
Corporate tax	Estimated average buoyancy of 1.98	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 2.19
Union excise duty	Estimated average buoyancy of 0.5 for Non-POL and 1 for POL. The overall buoyancy is estimated at 0.75	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 0.98
Customs	Estimated average buoyancy of 0.54	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 0.06
Service tax	Estimated average buoyancy of 1.77	Baseline estimates adjusted for policy proposals and administrative reforms yielding a buoyancy of 5.39
Education cess	2 percent of all taxes	Maintain the ratio of education cess to all other central taxes in the year 2004-05
Non-tax revenues		
Interest income	Reduction of 5 percent per annum	Reduction of 7.5 percent per annum over 2004-05
Dividend	Annual growth rate of zero percent.	Annual growth rate of 2.5 percent.
Other non-tax revenue	Annual growth rate of 5 percent.	Unchanged

though the task is daunting, it is not out of reach.

One of the important consequences of the tax driven fiscal correction is that it will substantially improve the fiscal health of state governments. An increase of 2.88 per cent of GDP in gross tax revenues of the centre will result in a direct improvement of State revenues of about 0.9 per cent of GDP, going by existing sharing formulas. This will in turn help states to overcome their revenue deficit and put a halt to increasing debt burden.

The reforms projections envisage that customs collections will drop from 1.72 per cent of GDP in 2004-05 to 1.03 per cent of GDP in 2008-09, reflecting India's convergence to ASEAN levels of customs tariffs. Tax collections from the services sector are projected to rise sharply, from 0.45 per cent of GDP in 2004-05 (BE) to 2.14 per cent of GDP in 2008-09.

6.2.2 Fiscal projections for reforms scenario

Table 6.10 shows the full projections for the reforms scenario, measured in crore rupees.

Table 6.7 Expenditure assumptions underlying baseline versus reforms scenarios

	Baseline	Reforms
Non-plan expenditure		
Interest payments	Weighted average interest rate of 8.25 percent	Unchanged.
Defence expenditure	Annual growth rate of 8.73 percent after adjusting for the one-time additionality in 2004-05 for capital expenditure.	To be marginally increased in 2005-06 and thereafter stabilised at 2.3 percent of GDP.
Subsidies		
Food	Reduction of 5 percent per year	Unchanged.
Fertilizer	Annual growth rate of 5 percent.	Unchanged.
Others	Petroleum subsidy to be phased out after 2006-07	Unchanged.
Grants, loans to States, UTs	Annual growth rate of 6 per cent	Annual growth rate of 5.5 per cent. Pending finalisation of the details of the program, a sum of Rs.5,000 crore in 2006-07, Rs.7,500 crore in 2007-08, and Rs.10,000 crore in 2008-09 have been additionally provided for the Backward States Grant Commission under this head.
Other non-plan exp.	Annual growth rate of 6 percent.	Annual growth rate of 5.5 percent.
Plan expenditure	12.82 percent increase per annum	Accelerated annual growth rate of 15 percent after 2004-05.
Capital expenditure	To maintain the ratio of capital expenditure to total expenditure at the 2003-04 level	To steadily increase capital expenditure, so that in 2008-09 it is about 0.5 percent of GDP higher than the baseline projection for 2008-09.

Table 6.8 Reforms scenario tax projections (Rs. crore)

This table shows tax projections, under the reforms scenario, expressed in crore rupees. It may be compared against Table 3.2 which shows the corresponding baseline scenario.

	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09	Growth 0405-0809	Buoyancy
Direct taxes	103,400	137,000	160,883	209,070	260,565	320,405	25.38	2.06
Income tax	40,269	50,009	55,310	74,744	92,130	112,042	22.71	1.84
Corporation tax	62,986	86,846	105,573	134,326	168,436	208,363	27.03	2.19
Indirect taxes	151,523	175,823	217,481	254,867	285,735	320,343	16.15	1.31
Excise	92,379	107,699	110,491	130,941	146,357	163,507	12.10	0.98
Customs	49,350	53,500	46,980	45,342	48,221	51,269	0.77	0.06
Service tax	8,300	14,000	60,010	78,584	91,157	106,326	66.54	5.39
Gross tax collection	254,923	312,823	378,363	463,937	546,301	643,287	20.34	1.65
Education cess	0	4,910	5,939	7,282	8,575	10,097		
Total gross taxes	254,923	317,733	384,302	471,219	554,875	653,384	20.71	1.68
GDP at market prices	27,72,194	31,04,857	34,77,440	39,03,426	43,91,355	49,62,231	12.35	

Table 6.9 Reforms scenario tax projections: Per cent to GDP

This table shows tax projections under the reforms scenario, where all values are expressed as per cent to GDP. It may be compared against Table 3.3, which shows corresponding values under the baseline scenario.

(Per cent to GDP)

Financial Year	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09
Direct taxes	3.73	4.41	4.63	5.36	5.93	6.46
Income tax	1.45	1.61	1.59	1.91	2.10	2.26
Corporation tax	2.27	2.80	3.04	3.44	3.84	4.20
Indirect taxes	5.47	5.66	6.25	6.53	6.51	6.46
Excise	3.33	3.47	3.18	3.35	3.33	3.30
Customs	1.78	1.72	1.35	1.16	1.10	1.03
Service tax	0.30	0.45	1.73	2.01	2.08	2.14
Gross tax collection	9.20	10.08	10.88	11.89	12.44	12.96
Education cess	0	0.16	0.17	0.19	0.20	0.20
Total gross taxes	9.20	10.23	11.05	12.07	12.64	13.17

The projections envisage a small revenue surplus of Rs.7,429 crore in 2008-09. Table 6.11 shows the same information, expressed as per cent to GDP.

Gross tax revenues are projected to rise from 10.23 per cent of GDP to 13.17 per cent of GDP, an increase of 2.94 percentage points. Given the assumptions about stable nominal disinvestment proceeds, 'Other receipts' are projected to drop from 0.13 per cent of GDP to 0.08 per cent of GDP. Total receipts are projected to be 14.3 per cent of GDP in 2008-09.

Interest costs are projected to drop from 4.17 per cent of GDP to 3.54 per cent of GDP. Defence expenses are projected to be stable at 2.3 per cent of GDP from 2006-07 onwards. Subsidies are projected to steadily drop to 0.8 per cent of GDP. Grants and loans to States and Union Territories are projected to rise to 0.96 per cent of GDP.

Plan expenditure is projected to rise from 4.69 per cent of GDP in 2004-05 to 5.13 per cent of GDP in 2008-09. The decline in total expenditure is projected to be concentrated in revenue expenditure. Capital expenditure is projected to go up from 2.97 per cent of GDP to 3.27 per cent of GDP.

This fiscal planning effort projects a small revenue surplus in the terminal year 2008-09. It should be highlighted that this is a small revenue surplus, so there is little 'slack' available in this set of projections. The improvement in the revenue deficit in every year, and the terminal year values, conform to the requirements of the FRBM Rules.

The fiscal deficit is projected to drop to 2.8 per cent of GDP in 2008-09. The drop in the fiscal deficit in every year conforms to the requirements of the FRBM Rules.

Figure 6.1 compares the baseline scenario against the reforms scenario on the revenue deficit. Under the baseline scenario, some progress on the revenue deficit (as per cent of GDP) is expected. However, the revenue deficit is expected to be quite substantial in 2008-09. In contrast, the reforms scenario delivers a trajectory through which the

Table 6.10 Fiscal projections under reforms scenario (Rs. crore)

This table shows fiscal projections under the baseline scenario, expressed in crore rupees. It may be compared against Table 3.5, which shows corresponding values under the baseline scenario.

(Rs. crore)

	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09
GDP	27,72,194	31,04,857	34,77,440	39,03,426	43,91,354	49,62,231
Gross tax revenue	254,923	317,733	384,302	471,219	554,875	653,384
Revenue receipts	263,027	309,322	357,066	420,758	482,441	554,712
Tax revenue, net to centre	187,539	233,906	282,969	347,713	410,191	483,014
Non-tax revenue	75,488	75,416	74,097	73,045	72,250	71,698
Capital receipts	164,626	168,507	161,131	155,001	153,525	154,835
Recoveries of loans	18,023	27,100	16,895	12,225	12,089	12,089
Other receipts	14,500	4,000	4,000	4,000	4,000	4,000
Borrowings and other liabilities	132,103	137,407	140,236	138,776	137,436	138,746
Total receipts	427,653	477,829	518,197	575,759	635,966	709,548
Non-plan expenditure	306,146	332,239	350,768	383,216	414,542	454,910
Interest, debt servicing	124,555	129,500	141,545	152,997	164,333	175,769
Defence	60,300	77,000	77,981	89,779	101,001	114,131
Subsidies	44,707	43,516	44,497	43,924	39,883	39,672
Grants, loans to States,UTs	15,850	19,576	20,653	26,789	35,762	47,729
Other non-plan expenditure	60,734	62,647	66,093	69,728	73,563	77,609
Plan expenditure	121,507	145,590	167,429	192,543	221,424	254,638
Total expenditure	427,653	477,829	518,197	575,759	635,966	709,548
Revenue expenditure	362,887	385,493	418,394	462,559	496,760	547,283
Capital expenditure	64,766	92,335	99,803	113,199	139,206	162,265
Revenue Deficit	99,860	76,171	61,328	41,802	14,319	-7,429
Fiscal Deficit	132,103	137,407	140,236	138,776	137,436	138,746

revenue deficit is projected to go to zero by 2008-09, and revenue surpluses can then be obtained thereafter.

Figure 6.2 shows projections for the Debt/GDP ratio under the baseline scenario. Under the baseline scenario, this ratio is projected to worsen slightly in the coming few years. In contrast, the reforms scenario is projected to deliver a sharp improvement in the Liabilities/GDP ratio.

This is consistent with the framework observed in advanced countries, where the Liabilities/GDP ratio only declines in normal years, thus giving fiscal space for debt issuance when faced with emergencies. This also sets the stage for achieving the lower Liabilities/GDP ratios which are found with countries which have high credit ratings, which would pave the way for higher investment flows for the country.

The fraction of interest payments to revenue receipts (Figure 6.3) is a valuable indicator of fiscal stress. It shows the fraction of revenue receipts which have been pre-empted merely to meet interest payments. This ratio had risen to as high as 53.4 per cent in 2001-02;

Table 6.11 Fiscal projections under reforms scenario (Per cent to GDP)

This table shows the full set of fiscal projections under the reforms scenario, expressed as per cent of GDP. It may be compared against Table 3.6, which shows corresponding values under the reforms scenario. All the values in the table are consistent with the FRBM Act and with the FRBM Rules.

(Per cent to GDP)

	2003-04 (RE)	2004-05 (BE)	2005-06	2006-07	2007-08	2008-09
Gross tax revenue	9.20	10.23	11.05	12.07	12.64	13.17
Revenue receipts	9.49	9.96	10.27	10.78	10.99	11.18
Tax revenue, net to centre	6.77	7.53	8.14	8.91	9.34	9.73
Non-tax revenue	2.72	2.43	2.13	1.87	1.65	1.44
Capital receipts	5.94	5.43	4.63	3.97	3.50	3.12
Recoveries of loans	0.65	0.87	0.49	0.31	0.28	0.24
Other receipts	0.52	0.13	0.12	0.10	0.09	0.08
Borrowings and other liab.	4.77	4.43	4.03	3.56	3.13	2.80
Total receipts	15.43	15.39	14.90	14.79	14.48	14.30
Non-plan expenditure	11.04	10.70	10.09	9.82	9.44	9.17
Interest, debt servicing	4.49	4.17	4.07	3.92	3.74	3.54
Defence	2.18	2.48	2.24	2.30	2.30	2.30
Subsidies	1.61	1.40	1.28	1.13	0.91	0.80
Grants, loans to States,UTs	0.57	0.63	0.59	0.69	0.81	0.96
Other non-plan exp.	2.19	2.02	1.90	1.79	1.68	1.56
Plan expenditure	4.38	4.69	4.81	4.93	5.04	5.13
Total expenditure	15.43	15.39	14.90	14.75	14.48	14.30
Revenue expenditure	13.09	12.42	12.03	11.85	11.31	11.03
Capital expenditure	2.34	2.97	2.87	2.90	3.17	3.27
Revenue Deficit	3.60	2.45	1.76	1.07	0.33	-0.15
Change	0.80	-1.15	-0.69	-0.69	-0.74	-0.48
Fiscal Deficit	4.77	4.43	4.03	3.56	3.13	2.80
Change	-1.15	-0.34	-0.40	-0.47	-0.43	-0.33

i.e., more than half of revenues were taken up in merely paying interest.

The baseline scenario is projected to roughly deliver a stable ratio. However, the reforms scenario is projected to deliver sharp improvements in this ratio, going down to levels near 30 per cent by 2008-09. The continuation of revenue surpluses beyond is likely to give further reductions in this ratio in the following years.

Under the reforms scenario, the change in outlook on the Debt/GDP ratio, and on the fraction of revenue receipts used up to pay interest obligations, will send a sharp signal about India's fiscal consolidation from 2006-07 onwards, when progress will be manifestly visible.

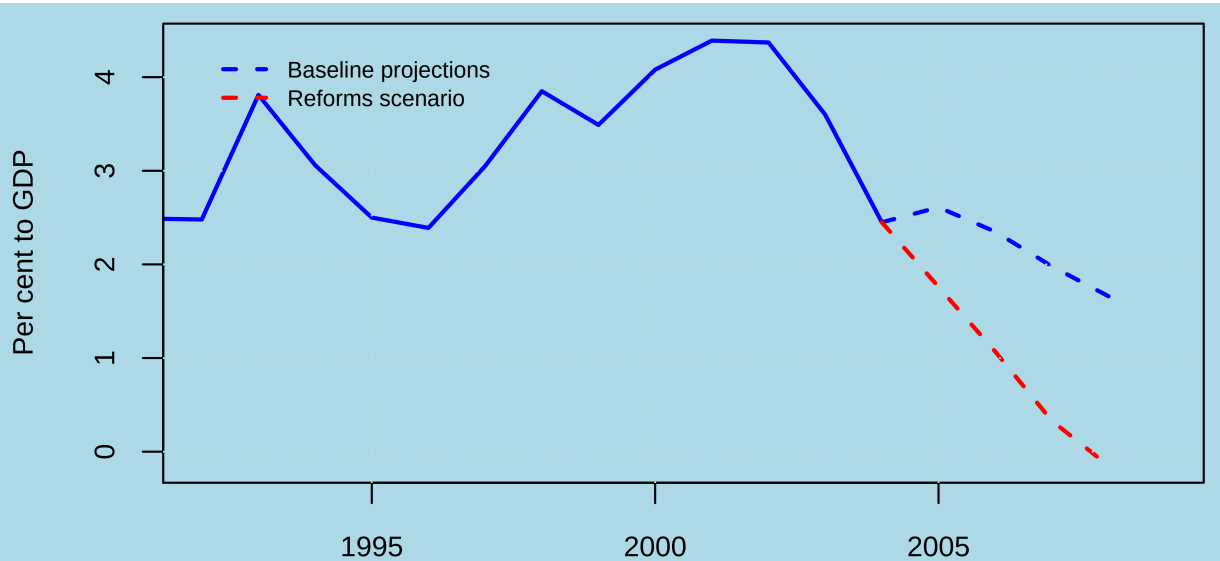
The discretionary expenditure of government is the non-interest part of total expenditure. This is the resource base that is available to expenditure policy, which can be utilised to produce public goods and also fund

Table 6.12 Comparing baseline and reforms scenarios

This is the data that underlies Figures 6.1, 6.2, 6.3 and 6.4.

Parameter	2004-05	2005-06	2006-07	2007-08	2008-09
Liabilities/GDP					
Baseline	68.51	68.85	69.09	69.07	68.92
Reforms	68.51	67.89	67.11	66.25	65.44
Difference		*-0.96*	*-1.98*	*-2.82*	*-3.48*
Revenue deficit to GDP					
Baseline	2.45	2.61	2.35	1.98	1.66
Reforms	2.45	1.76	1.07	0.33	-0.15
Difference		*-0.85*	*-1.28*	*-1.65*	*-1.81*
Interest / revenue receipts					
Baseline	41.87	44.50	44.01	42.90	41.48
Reforms	41.87	39.64	36.36	34.06	31.69
Difference		*-4.86*	*-7.65*	*-8.84*	*-9.79*
Non-interest expenditure to GDP					
Baseline	11.22	10.62	10.33	10.01	9.83
Reforms	11.22	10.83	10.83	10.74	10.76
Difference		*0.21*	*0.50*	*0.73*	*0.93*

Figure 6.1 Revenue deficit as per cent to GDP: Projections under reforms scenario



subsidies. The historical experience, and projections, for this (expressed as per cent to GDP) is shown in Table 6.4.

Under the reforms scenario, discretionary expenditure of government is projected to fall steadily to levels below 10 per cent by 2008-09. The reforms scenario is projected to deliver a stable value of roughly 11 per cent of GDP.

The numerical values underlying these

Figure 6.2 Liabilities as per cent to GDP: Projections under reforms scenario

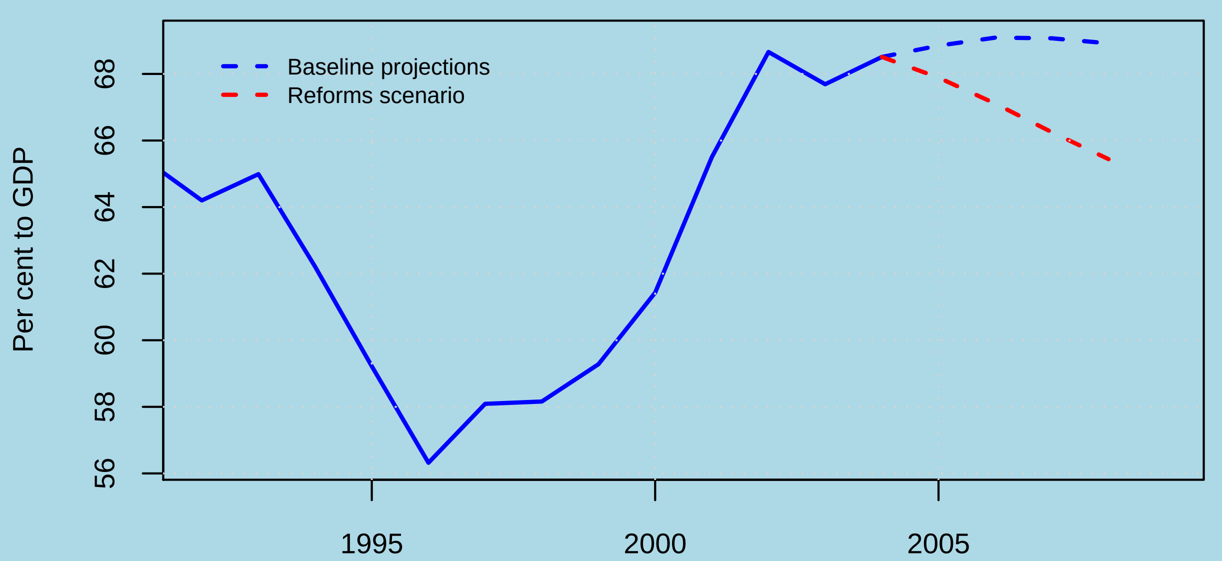
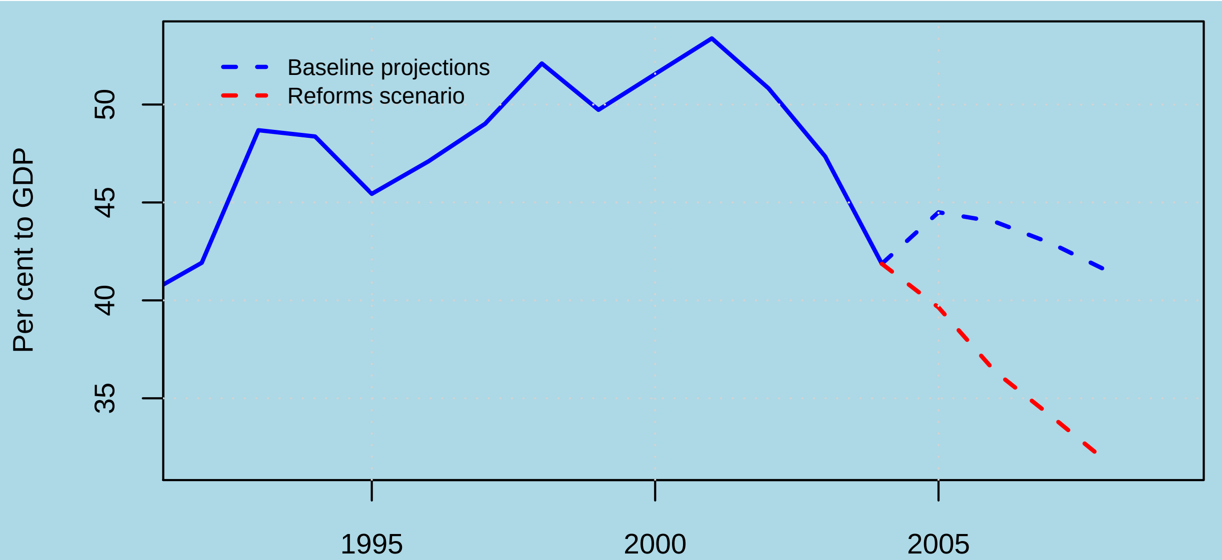
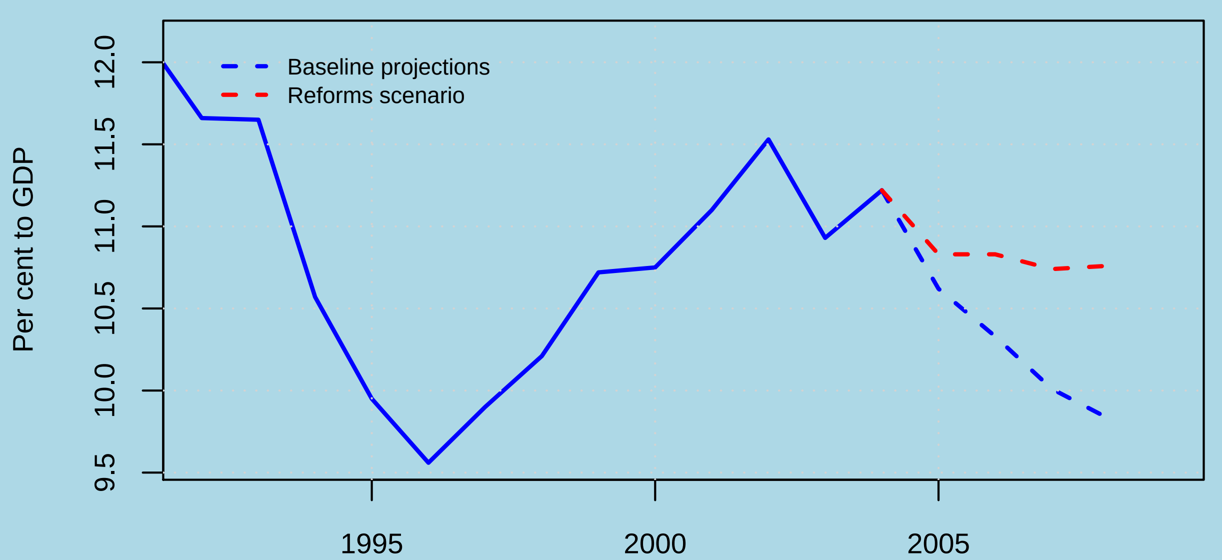


Figure 6.3 Interest payments as per cent to revenue receipts: Projections under reforms scenario



graphs are summarised in Table 6.12. The table highlights the fact that the reforms scenario improves upon the baseline projections on each parameter in each of the four years. In 2008-09, the Debt/GDP is projected to be lower by 3.48 percentage points; the revenue deficit is projected to be smaller by 1.81 percentage points of GDP; interest payments as a fraction of revenue receipts will be smaller by 9.79 percentage points, and the discretionary expenditure of government will be larger by 0.93 percentage

Figure 6.4 Discretionary expenditure as per cent to GDP: Projections under reforms scenario



points of GDP.

6.3 Sensitivity of projections to shocks

In this report, both baseline and reforms scenarios have been conducted assuming that all the years from 2004-05 till 2008-09 will be 'normal' years. In practice, some years will be better than normal and some years will be worse than normal.

One of the years could prove to be like 2002-03, with a sharp drop in output caused by a bad monsoon. One of the years could prove to be like 2003-04, with above-8 per cent GDP growth. The domestic and global business cycle constitute important sources of uncertainty for both revenue and expenditure projections. For example, the buoyancy of corporate tax collections in recent months has clearly been shaped by the strong profit growth of the companies of India in 2003-04.

The FRBM Act has set requirements which have to be met, regardless of these fluctuations in the macroeconomy. This highlights the need to have 'safety factors' in policy decisions, through which the FRBM targets will be successfully achieved, even if some difficulties are encountered along the way.

The policy proposals of this report, and the associated reforms scenario projections, have a little slack in two respects. First, the revenue deficit in 2008-09 is -0.15, i.e. there is an outperformance when compared with the target of 0. Second, the bulk of the task of eliminating the revenue deficit is projected to be completed by 2007-08, where the revenue deficit is projected to be 0.33 per cent of GDP.

At the same time, these 'safety factors' constitute relatively little space in coping with a downturn in the economy. This underlines the need to embark on front-loaded reforms, so as to reap the benefits in 2005-06 and 2006-07.

6.4 Need for care in evaluating alternative policies

Medium-term fiscal planning differs considerably from the traditional budgeting exercise. The fiscal projections shown for the reforms scenario are derived using complex calculations from the reforms proposed. When alternative policies are considered, they have complex implications for the medium-term scenario, which need to be factored into policy analysis.

For example, if the corporate tax reforms proposed in this report are implemented, while leaving the depreciation rate at 25% instead of reducing it to 15%, the consequences flow as follows. Corporate tax collections will prove to be lower. Hence, every year, the revenue deficit will be larger. This will lead to a larger build-up of debt. This will, in turn, feed into interest payments, which further changes the revenue deficit in following years.

This highlights the need for new ways of analysing, crafting and executing fiscal policy. Medium term fiscal planning needs to be adopted as the new conceptual framework, in order to successfully achieve the fiscal consolidation, meet the targets set by the FRBM Act, while avoiding hurting economic growth or resorting to inefficient policies on taxation or expenditure. This will be a lasting contribution of the FRBM Act to strengthening India's fiscal institutions.

Chapter 7

Impact of achieving FRBM targets

The FRBM Act is a milestone in India's economic history, in bringing about prudent fiscal policies. The implementation of this Act involves significant reforms to both revenue and expenditure.

This report proposes a paradigm shift in the tax system as the main means of achieving the FRBM Act requirements. This will give India a world class fiscal system. This tax system will be fair and equitable, and conducive to high economic growth. This chapter sketches the important consequences, and the impact upon the economy, of the policy proposals of this report.

7.1 World class tax system

The tax reforms proposed in this report seek to help India achieve a world-class fiscal system. This would be the most equitable tax system in India's post-independence period.

These reforms address the great degree of distorted behaviour that takes place today, in the portfolio formation of households, in the consumption versus savings decisions of households, in corporate financial structure, and in the industries where investment takes place. The attention of the companies of India should be on productivity and global competitiveness; not on tax planning. The removal of these behavioural distortions will improve the efficiency of resource allocation, and yield faster GDP growth.

A major distortion that will be addressed is the differential treatment of manufacturing versus services. The manufacturing sector, today, pays a disproportionate burden of total tax revenues, even though the services sector now exceeds half of GDP. By correcting this imbalance, with a uniform goods and services tax, the proposed tax reforms will bring neutrality between manufacturing and services. This will help spur a boom in investment in Indian manufacturing and agro-business, and particularly labour-intensive exports growth. This is likely to help in the creation of a large number of blue-collar jobs in the manufacturing sector including agro-processing industries and in rural areas, as has been observed in China.

The proposed tax reforms will have a major impact upon the economy in terms of the reduction of compliance costs. The present processes of recordkeeping and tax filing impose substantial costs upon both the taxpayer and government. These are deadweight costs for the economy. The proposed reforms would yield a sharp reduction in compliance costs, and thus free up resources for productive uses.

Another key beneficiary of the tax reforms will be small and medium enterprises (SMEs), which today bear a disproportionate brunt of taxation owing to the regressive nature of exemptions and the regressive impact of costs of compliance. This is a key sector where labour-intensive and export-intensive growth needs to come about to sustain high growth in GDP and employment.

The proposed tax reforms will enhance equity. A complex tax system is inherently regressive, in that large entities are more able to engage in tax planning and tax avoidance. The compliance costs associated with a complex tax system also inherently have a higher incidence, as percent of income, upon individuals with smaller incomes and upon small firms. Simplifying the tax system inherently redresses this balance.

7.2 Impact on investment

The reforms proposed in this report will have a strongly positive impact upon investment at many levels, promoting 'investment-led' growth.

Public capital expenditure. Under the baseline scenario, capital expenditure was projected to drop from 2.5% of GDP in 2002-03 to 2.3% of GDP in 2008-09. There is a strong consensus amongst economists that public capital expenditure - if conducted through sound institutional mechanisms like NHAI - performs a valuable role in our growth process, and will actually 'crowd-in' private investment.

Under the reforms scenario, capital expenditure is projected to go up to 2.9% of GDP in 2008-09. This is a difference of 0.6% of GDP when compared with the baseline scenario. For a frame of reference, the capital expenditure of NHDP amounts to 0.3% of GDP, so 0.6% of GDP is large enough to support two programs of the size of NHDP.

Improvement in credit rating. The improvement in India's fiscal situation is likely to lead to an improvement of India's credit rating. This would spur foreign capital inflows into India, and thus help investment in the country.

Impact on private investment. A strong program of effective public investment is known to 'crowd in' private investment. The easing of the fiscal constraints faced by the government would help improve the provision of public goods, which would lead to an improved investment climate. The improvement in India's outlook owing to fiscal consolidation would improve the investment intentions of domestic and foreign investors.

7.3 Impact on manufacturing

The tax reforms proposed in this report would give a strong boost to Indian manufacturing. Through this, they would impact on investment in manufacturing and job creation. The impact on manufacturing takes place through the following elements:

- The CENVAT burden on manufacturing is proposed to go down from 16 per cent to 12 per cent. This is a direct reduction of the tax burden on manufacturing.
- Manufacturing firms are significant consumers of services. However, at present, they do not get CENVAT credit for the service tax that is embedded in their purchases of services. Under a single GST, manufacturing firms would get

credit for the GST that is embedded in their purchases of services.

- The manufacturing sector is a major exporter, particularly in areas like textiles and engineering goods. As highlighted above, a modern fiscal architecture sets the stage for integration into global production networks and an export orientation. The manufacturing sector would be the major beneficiary of this transformation.
- The proposed structure of GST plus state VAT would eliminate the existing situations where Indian firms actually face negative rates of protection.
- The proposed tax reforms involve a lower peak rate, which improves the post-tax returns on equity. They also better address the problems of dividend tax. Through these, manufacturing firms would face greater neutrality between alternative forms of financing and alternative forms of organisation. This would help firms design their organisational and financial structure based on pure efficiency considerations, with smaller tax-induced distortions.

7.4 Impact on exports

The rationalisation of taxation of goods and services would have an enormously positive impact on exports from the country.

A central feature of global production today is the phenomenon of breaking up production into long production networks that are spread all over the world.

The traditional vision of manufacturing consists of a long assembly line, starting from primary raw materials and ending in finished goods. However, in the last 40 years, this long assembly line has been broken up across multiple locations spread across the world, in the quest for the highest efficiency for each step in the overall production process.

Global production now takes place at highly specialised and highly efficient production centres. Raw materials get shipped to these centres, a small amount of value added takes place, and the products get shipped to another highly specialised and highly efficient production centre.

This implies that the value added at any one location of production is relatively small when compared with the value of output. Globally oriented firms tend to have high turnover but relatively low value added.

For these firms, distorted taxation can be a major factor affecting investment decisions. If revenues of Rs.100 are based on value added of Rs.20, then a distortion in taxation of Rs.2 works out to 10% of the value added. While a value like Rs.2 appears small when compared to a base of Rs.100, it should appropriately be compared with the value added and not the turnover. In this case, small mistakes in taxation can be large enough to make or break the viability of a proposed organisation of production.

In this situation, there is only one correct architecture for the fiscal system, illustrated in Figure 7.1, which consists of the following four elements:

1. *All imported goods should face a near-uniform and low tariff.*

   This avoids the anomalous rates of effective protection that can come about from apparently minor differences between customs duties.

2. *Imported goods should be charged a CVD at the point of entry, reflecting the domestic GST plus the state VAT.*

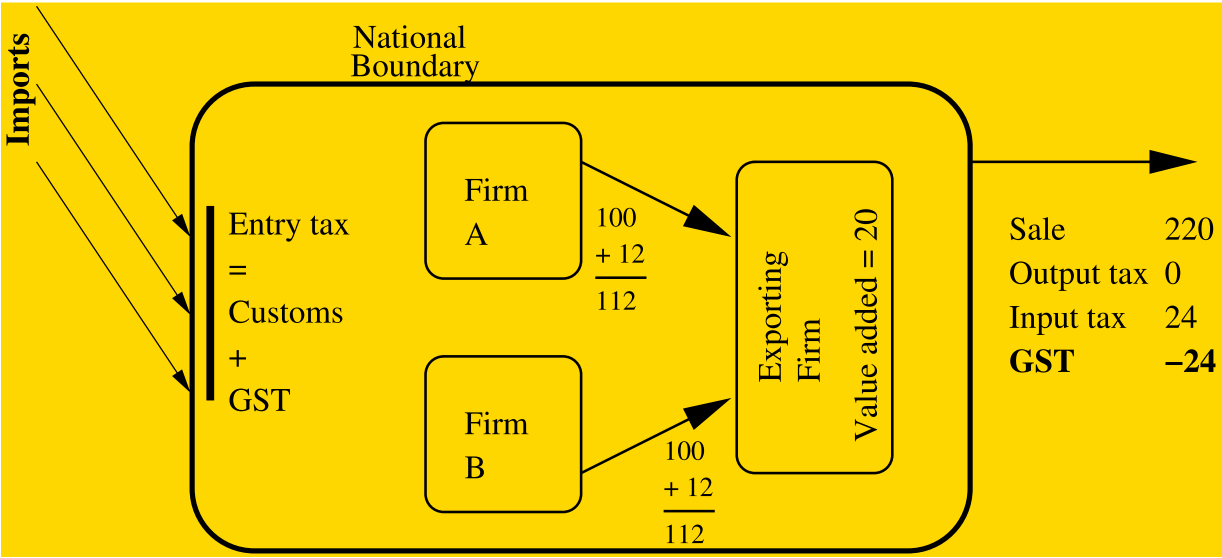
   This avoids situations with negative rates of protection.

3. *The domestic export-oriented factory should buy numerous goods and services domestically, but be able to clearly identify the GST and state*

Figure 7.1 Treatment of imports and exports in a GST framework

The figure shows an example of the treatment of imports and exports in a GST framework.

- Imports are charged a combination of customs and GST. Imported goods would find their way across the economy at many levels in complex networks of production.
- Firm A and Firm B are each suppliers of goods and services to an exporting firm. Each of them sells goods/services worth Rs.100, which attracts a GST of Rs.12 at the rate of 12%.
- The exporting firm has a value added of Rs.20. The exported goods are worth Rs.220.
- Since exports are zero-rated in a GST, the output tax is 0. The input tax embedded in the raw material purchases are Rs.24. Hence, the GST applicable for the exporting firm is -24. Thus the GST embedded in exports is 'refunded' to the exporting firm.



VAT that is embedded in the prices paid for all these.

This is a much superior framework as compared with the present situation, where refunds that come back to firms are necessarily incomplete. In particular, at present, the services purchased by manufacturing firms at present contain a component of the service tax, but no credits are given reflecting this.

4. *As the product is leaving the country, the domestic factory should get back a refund of the GST and state VAT that is embedded in the goods that are leaving, which is the sum of all the GST and state VAT that has gone into the product, through a state of the art IT system without a human interface with the tax administration.*

   This is a much superior framework when compared with the transactions costs involved in dealing with the export subsidy programs.

The business model of the hypothetical firm depicted in Figure 7.1 critically relies on the ability of the State to correctly know that the GST embedded in its production process is Rs.24, and for this GST to be refunded. If, hypothetically, there was a mistake in tax policy, and the GST payment to the exporter came out to only Rs.20 instead, then this apparently small difference of Rs.4 – which is merely 1.8% of the value of exported goods – looms large as 20% of the value added of this firm.

For India to emerge as a major powerhouse in the evolving global economy, it is ***crucial*** *to have this sound fiscal architecture comprising of near-uniform customs rates, well coordinated central and state GST, with efficient payment of credits at the point of export.* The tax reforms proposed in this report seek to achieve precisely this goal.

China is universally seen as a success story in export-oriented manufacturing which is integrated into global production networks. The modernisation of the tax system which took place in China, and was well in place by the early 1990s, was an integral part of the Chinese strategy for rapid export-driven and manufacturing-driven growth. These very elements – low and near-uniform tariffs plus an efficiently implemented GST – were in place in China by the early 1990s. They have helped pave the way for the massive expansion of Chinese exports which took place in the last decade.

The second aspect of the impact of the proposed tax reforms on exports lies in the SME sector, which tends to often involve labour-intensive firms and export-orientation. Dynamic export-oriented firms like Infosys all started out as SMEs. The existing complex exemption-ridden tax structure is regressive; it imposes smaller taxes on big companies, who are more equipped to pay the fixed costs of tax compliance and tax planning.

The tax reforms proposed in this report would make it easier for small and medium export-oriented firms to stay focused on issues of productivity and markets, instead of devoting resources to interacting with the tax system. For example, the existing system of duty drawback is limited to direct imports by the exporting firm. This distorts the structure of production in favour of excessively vertically integrated firms, and hurts efficiency. Small firms are disadvantaged since they would find it harder to import directly.

The tax reforms proposed in this report would hence have a powerful impact on exporting, at two levels. For the largest firms, they set the stage for thinking in terms of global production networks, and the establishment of very large factories that cater to the global market. They also free up small export-oriented firms from the existing regressive tax burden. In both kinds of firms, they serve to spur expansion into global markets, investment and hence job creation.

7.5 Impact on the financial sector

At present, the average tax paid by finance companies is disproportionately high, when compared with manufacturing, owing to the use of the existing depreciation treatment for tax planning by manufacturing companies. The proposed tax reforms of this report bring neutrality in this. Through this, the average tax burden on finance companies would go down.

For savers, the proposed tax reforms would largely eliminate the distorted portfolio formation that has come about in the quest for tax planning. Each individual and each household would form a better portfolio, in the sense of choice of risk and return, without tax distortions.

The financial sector would play a bigger role in the economy once the resource pre-emption of the government goes down. This would pave the way for greater growth in equity and debt financing for corporations.

The proposed tax reforms would bring about greater neutrality between equity and debt financing, and between alternative forms of organisation and fund management. This would yield a more efficient and vibrant financial system, which would be more focused on issues like productivity and information processing, as opposed to distorted behaviour motivated by tax considerations.

The present structure of risk and return across financial products in the system contains several anomalous products, with unusually high post-tax returns, owing to special exceptions embedded in the tax code. The reforms proposed in this report gradually phase out all these special cases. They usher in a single logically consistent EET system of taxation for the first Rs.100,000 of saving. Through this, the risk/reward profile present in the financial markets would attain a rational structure.

7.6 Impact on state finances

State governments are crucial to governance and development in the country. State finances would obtain an enormous boost, under the proposals of this report, through four channels:

1. The increase in Central gross tax revenues – of roughly 3 percentage points of GDP – would innately increase resource transfers to the States of roughly 1 percent of GDP.
2. States would benefit by the proposed extension of services as their tax base.
3. States would benefit by the proposed imposition of State VAT on imports, which would accrue to them.
4. Higher plan expenditure will be associated with larger resource flows to States through states and UT plans.

These benefits are, however, a part of a 'grand bargain' between the Centre and the States, as outlined above, which does require States to coordinate their fiscal reforms with this shift to the GST.

7.7 Impact on health and education

A major goal in Indian economic policy today is to improve outcomes on health and education. A substantial increase in expenditure, coupled with radical expenditure reforms in order to find new instrumentalities for achieving sound outcomes, is required in order to address this problem.

These expenditures would generally take place under state finances, and under the rubric of 'plan expenditure'. As argued above, the tax reforms proposed in this report would have an enormous impact on state finances. This will create the fiscal space for state governments to refocus their energies on the problems of local public goods like drinking water, primary education and public health. If these resources can be effectively delivered into the production of local public goods, while simultaneously re-engineering institutional mechanisms, then it can have a considerable impact on the health and education outcomes in the country.

7.8 Impact on prices

A successful fiscal consolidation has an impact on the outlook on prices, by removing the possibility of inflation when faced with acute fiscal stress.

The introduction of VAT has now taken place in numerous countries, and there is an ample international experience which can be drawn upon in order to envision the consequences. This event is known to be associated with a small one-time increase in prices, as the VAT ultimately falls upon final consumers. This is only a one-time effect.

This logic, however, applies only when VAT is introduced for the first time in a previously untaxed area. This effect does not necessarily apply when the VAT replaces existing distortionary cascading taxes. In some situations, the shift from cascading taxes to a VAT can actually lower prices.

Hence, it is useful to distinguish between three classes of goods, in envisioning the impact of the proposals of this report upon inflation:

Unprocessed food, etc. The GST proposal of this report does not envisage taxing food.

Manufactured goods Put together, the proposals of this report will give lower prices of manufactured goods, for three reasons: (a) The GST proposal of this report envisages lower rates for manufactured goods, as compared with the existing CENVAT rates, (b) The removal of cascading taxes will lead to lower prices, (c) The reductions in customs duties proposed in this report would yield lower domestic prices.

In previous discussions on the effect of introduction of the State VAT on prices, the tax rates which have been analysed were chosen in order to achieve revenue neutrality against the existing cascading sales tax. This report critically differs from that discussion, insofar as the proposed State GST, at the rate of 8% on goods, is not revenue neutral when compared with the sales tax on goods. Revenue enhancement, under the proposals of this report, are derived from the extension of the State GST to services.

Services This report proposes that GST exemption should be given to services such as medical services, school and college education, educational loans, home loans, etc. The GST proposal of this report will give a one-time increase in the prices of other services, though this effect will be offset to some extent by the extent to which services producers will be able to buy manufactured goods at lower prices.

In addition, at a macroeconomic level, to the extent that the VAT is a consumption tax, and generates a bias in favour of savings, there will be a negative effect on prices through a slight increase in the savings rate.

Hence, we may expect that there would be a one-time negative effect on the WPI, which focuses on goods, there might possibly be a one-time increase in the GDP deflator.

7.9 Impact on the expenditure/GDP ratio

Under the baseline scenario, the expenditure/GDP ratio is projected to go down from 15.4% of GDP in 2003-04 to 13.7% in 2008-09. This is a fairly sharp compression of expenditure, by 1.7 percentage points.

A major feature of the proposed reforms is the improvement in the Interest/GDP ratio. Under the baseline scenario, Interest/GDP was projected to go down from 4.5% of GDP in 2003-04 to 3.9% of GDP in 2008-09. Under the reforms scenario, this is projected to drop further to 3.5% of GDP. This reduction will alleviate fears about future debt dynamics, and alleviate the pressure on public expenditure that has come from the steadily escalating interest burden.

Under the reforms scenario, the expenditure/GDP is projected to be higher at 14.3%

in 2008-09. The impact of the reforms scenario on non-interest expenditure is stronger: these are projected to go up from 9.8% of GDP under the baseline scenario to 10.8% of GDP under the reforms scenario. The reforms scenario utilises the improvements in the tax system, and the reduced interest outgo, to deliver a higher non-interest expenditure/GDP ratio, while at the same time removing the revenue deficit.

At the same time, the level of non-interest expenditure of roughly 11% of GDP is consistent with the international experience for a modest level of government expenditure. Under the reforms scenario, the proposed tax reforms are primarily focused on eliminating the revenue deficit, and not on growing the size of government expenditure.

There is, of course, an enormously important parallel set of questions of expenditure reforms, so as to refocus and restrict expenditure to *efficient* production of *public goods*. This question is distinct from the problem of removing the revenue deficit, and putting government finances back in balance.

7.10 Impact on defence expenditure

Defence expenditure has been constantly compressed owing to fiscal stress. In the baseline scenario, defence expenditure was projected to drop from 2.3% of GDP in 2002-03 to 2.0% in 2008-09.

Under the reforms scenario, this process is proposed to be halted, and defence expenditure will be stabilised at 2.3% of GDP. In the terminal year, this difference of 0.3 percentage points corresponds to more than Rs.12,000 crore.

7.11 Reduced crowding out

The first and most direct impact of achieving the FRBM targets would be a reduction in GOI borrowing. However, in our proposed reforms scenario, part of this is reversed using a higher proposed scale of capital expenditure. Through this, the gross fiscal deficit, which is 4.0% in the baseline scenario, is smaller at 2.8% of GDP in the reforms scenario.

This difference - of 1.2% of GDP - is the reduction in government's claims on the savings of the economy. This would lead to lower interest rates for households and firms that seek to access equity and debt capital, and generate higher GDP growth.

7.12 Complementarity with other aspects of reform

The reforms to the fiscal system proposed in this report, which are narrowly motivated by the FRBM Act, should necessarily be seen in the larger context of the economic reforms agenda, across numerous areas, in the country:

- Agricultural reforms
- An active competition policy
- Financial sector reforms
- Infrastructure reforms
- Promotion of FDI
- Improved governance of PSUs
- Governance reforms
- Human resource development.

The fiscal reforms proposed in this report dovetail well with each of the above initiatives. There are intimate synergies, and increasing returns to scale, in undertaking all these efforts as part of a coordinated effort to lift India's growth and obtain decisive progress on the elimination of mass poverty.

7.13 Impact on growth and employment

All these envisioned implications of the reforms proposals of this report add up to a scenario where India is likely to experience a considerable acceleration in GDP growth, and deliver high quality growth. The argument centrally rests on three elements:

- The first element lies in *removing tax-induced distortions*. The existing fiscal system has led to large-scale misallocation of resources. Tax reforms in India are likely to be expansionary through their impact on productivity. The behaviour of individuals and firms in India is greatly distorted by tax compulsions. In a simple, rational tax system, individuals and firms will make decisions based on economic principles, and considerations of efficiency and productivity, instead of being driven by tax planning.

- The second major factor is the issue of crowding out, i.e. the *pre-emption of financial savings by the government*. Tax reforms will free up greater resources for both equity and debt investment in the country. The fiscal consolidation will inspire confidence in the outlook for India, in the eyes of both domestic and foreign investors.

  In particular, the tax reforms proposed in this report will lower the cost of equity capital, and encourage entrepreneurship. They are consistent with a vision of investment-led growth for the coming five years.

- The third major factor is the *improved governance* made possible by easing the fiscal pressures upon government. This easing of resource constraints will greatly improve the quality and quantity of public goods that are provided. The growth implications of improved public goods, such as NHDP, is likely to be considerable.

In Section 3.3, it was argued that in computing the baseline scenario, there is a likelihood of slower GDP growth in the future owing to the fiscal problems. Under the reforms scenario, the opposite effects come into play, as shown in Table 6.1 which shows projections for GDP under the reforms scenario.

This difference in outlook, induced by reforms to the tax system, translates to *an improved GDP in 2008-09 of Rs.1,30,863 crore*. In other words, GDP in 2008-09 would be higher by Rs.1,30,863 crore if the fiscal system is reformed, as compared with the GDP that is likely to obtain in 2008-09 under present trends. This is an economically significant value, and highlights the materiality of embarking upon fiscal reforms.

Assuming a 60% labour share, an incremental Rs.78,518 crore of wage income would be injected into the economy in the year 2008-09 if fiscal reforms are taken up, which would impact on wages and employment. Higher GDP would have a powerful impact on poverty.

The proposals of this report are aimed at achieving success in meeting the goals defined in the FRBM Act. Fiscal consolidation will have far-reaching implications by giving fiscal flexibility to macroeconomic policy in the country. For example, when faced with monsoon shocks, or business-cycle fluctuations, there will be a possibility of having more activist fiscal policy.

On June 7, 2004, in his address at the first session of both Houses of Parliament after the elections to the 14th Lok Sabha, the President of India said:

> *Our people possess a vast pool of creative energies. They are eagerly waiting for the improvement in processes of governance for fuller utilisation of these energies for the task of nation building. All of us have an obligation to make the 21st century as India's century. India is destined to emerge as a major powerhouse of the evolving global economy and in the process also get rid of the chronic poverty, ignorance and disease which still affect large sections of our society.*

The reforms proposed in this report will help put India on this trajectory.

Appendix A

Estimation of tax buoyancies

A.1 Questions and methods

In this appendix, we address the question of estimation of the empirical experience with tax buoyancies. This effort in measurement fed into the judgments and assumptions that went into the baseline projections which are shown in Section 3.5. At the same time, the numerical values used in that section are not narrowly driven by these empirical results.

If T is a time-series of tax collections and B is a tax base, then regressions of the form $\log T = \alpha_0 + \alpha_1 \log B + \epsilon$ are used in order to estimate α_1, which can be interpreted as the tax buoyancy, i.e. the average percentage change in T for a one percent change in B.

The T and B time-series are typically both $I(1)$, which introduces difficulties in estimation and inference which are not squarely addressed here. However, in order to obtain feedback on the economic significance of this problem, we also estimate the $I(0)$ regression consisting of percentage changes in T on percentage changes in B.

A key concern is the extent to which the very tax buoyancies have themselves been evolving over time, reflecting the considerable policy efforts which have been taking place in India, particularly in recent years. In addition to the overall estimates (from 1980 to 2003), we also compute rolling window regressions, with a window width of 5 years. Each of these regressions has limited statistical precision. The 95% confidence intervals of these buoyancy estimates are superposed on the graphs below, in order to ensure that we take cognisance of the innate limitations upon our knowledge.

These computations are applied on three questions of tax buoyancy: personal income tax, corporate income tax and non-POL excise. In the first two cases, overall GDP is treated as the tax base. In the latter case, manufacturing GDP is treated as the tax base.

A.2 Personal income tax

Figure A.1 shows trends in personal income tax collections, expressed as percent of GDP.

Table A.1 shows the overall OLS estimates for a log/log model explaining log personal income tax as a function of log GDP. A regression of percentage changes on percentage

Table A.1 Personal income tax and GDP

	Estimate	t statistic
Intercept	-7.189	-28.02
log(GDP)	1.198	62.87

Figure A.1 Growth of personal income tax as percent of GDP

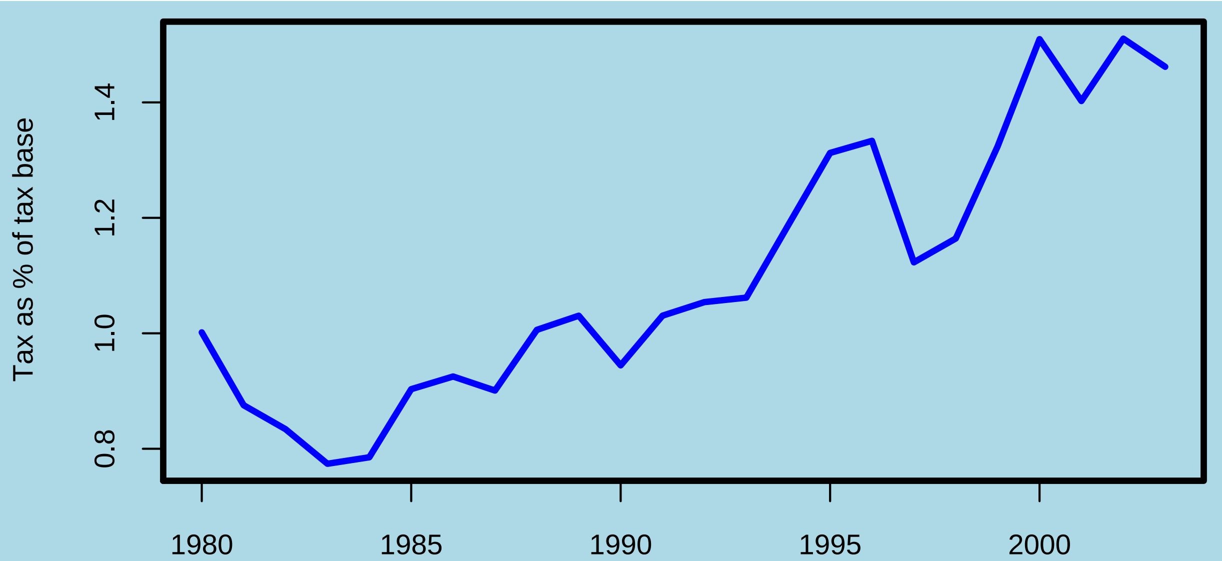
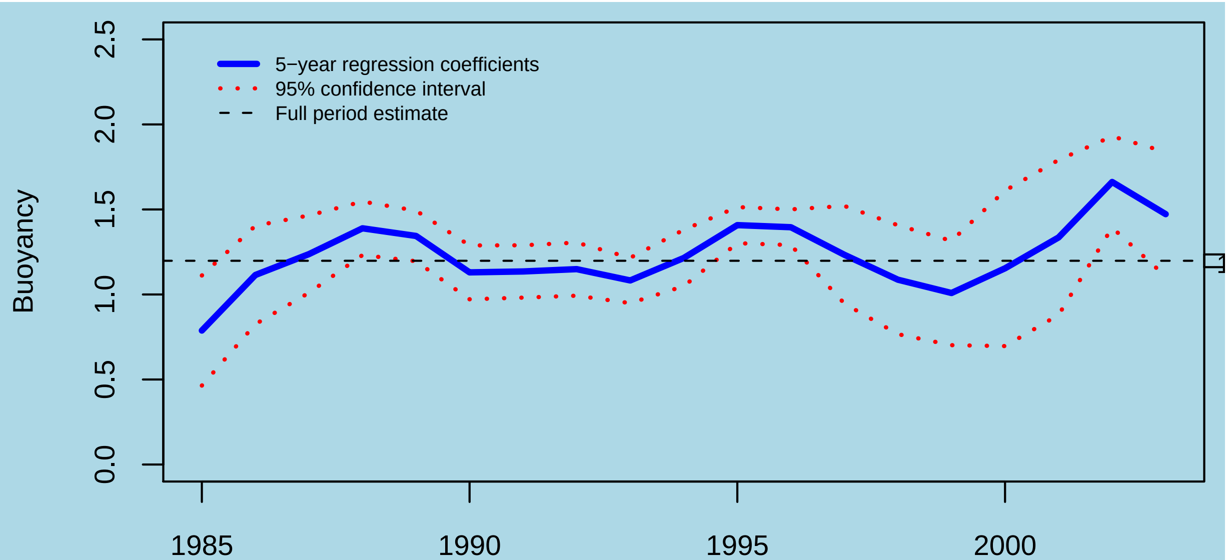


Figure A.2 Five-year rolling window estimates of buoyancy of personal income tax



changes yields a similar coefficient, of 1.12.

In order to focus on the evolution of the tax buoyancy over time, Figure A.2 shows five-year rolling window estimates of the log/log regression. In the latest two years, the five-year OLS estimates have been 1.66 and 1.47 respectively.

Figure A.3 Growth of corporate income tax as percent of GDP

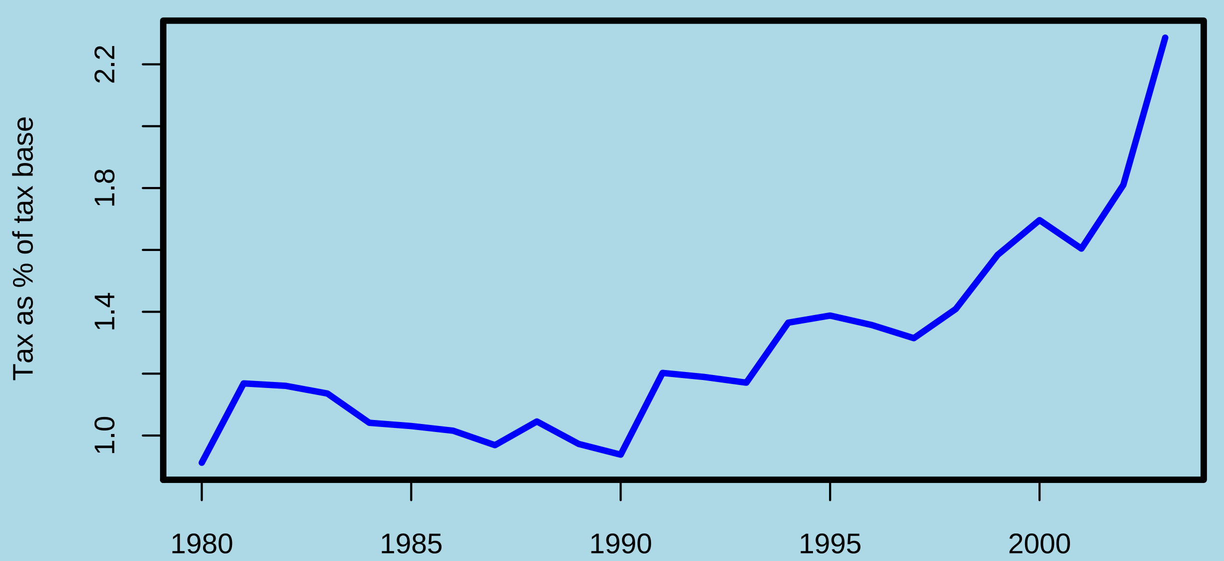


Table A.2 Corporate income tax and GDP

	Estimate	t statistic
Intercept	-7.129	-18.25
log(GDP)	1.204	41.52

A.3 Corporation tax

Figure A.3 shows trends in corporate income tax collections, expressed as percent of GDP.

Table A.2 shows the overall OLS estimates for a log/log model explaining log corporate income tax as a function of log GDP. A regression of percentage changes on percentage changes yields a similar coefficient, of 1.44.

In order to focus on the evolution of the tax buoyancy over time, Figure A.4 shows five-year rolling window estimates of the log/log regression. In the latest two years, the five-year OLS estimates have been 1.63 and 1.91 respectively.

Table A.4 Non-POL Excise and manufacturing GDP

	Estimate	t statistic
Intercept	0.815	3.20
log(GDP)	0.756	35.73

A.4 Non-POL Excise

Figure A.5 shows trends in non-POL excise collections, expressed as percent of manufacturing GDP. The data underlying this has not been previously released, hence it is shown in Table A.3.

Table A.4 shows the overall OLS estimates for a log/log model explaining log non-POL excise as a function of log manufacturing GDP. A regression of percentage changes on percentage changes yields a similar coefficient, of 0.7541.

In order to focus on the evolution of the tax buoyancy over time, Figure A.6 shows five-year rolling window estimates of the log/log

Figure A.4 Five-year rolling window estimates of buoyancy of corporate income tax

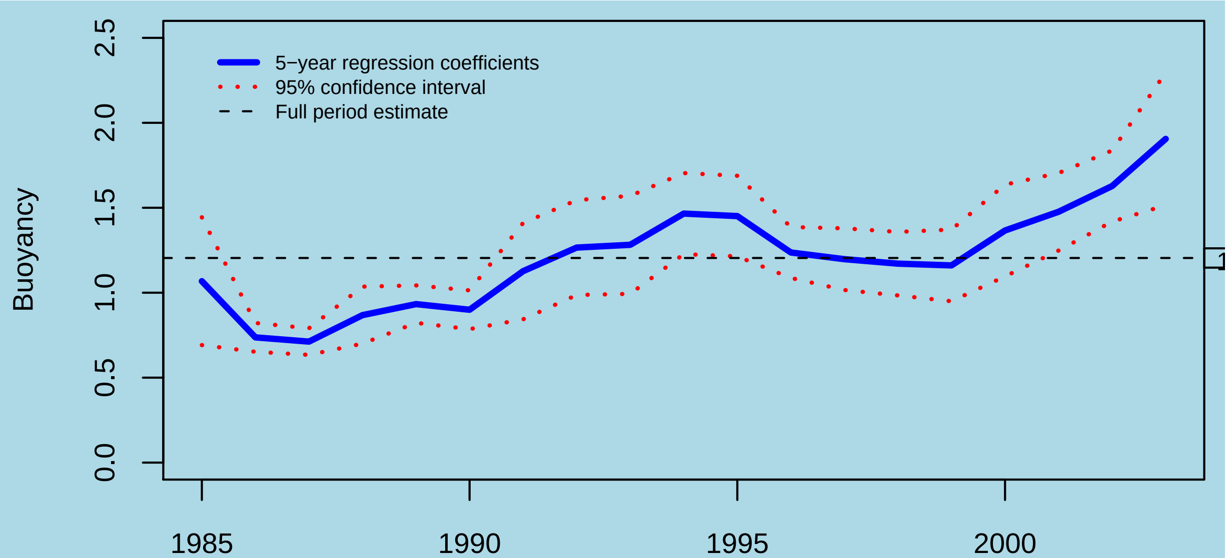


Table A.3 Breakup of excise collections: POL versus Non-POL

	Total Excise	POL Excise	Non-POL Excise	Non-POL Excise per Industry GDP
	(Rs. crore)			(Per cent)
1980-81	6500	1216	5232	16.41
1981-82	7421	1405	5998	15.56
1982-83	8059	1605	6346	14.51
1983-84	10222	2267	7869	15.38
1984-85	11151	2450	8466	14.52
1985-86	12956	2728	10200	15.49
1986-87	14470	3014	11393	15.41
1987-88	16426	3968	12378	14.68
1988-89	18841	4435	14303	14.21
1989-90	22406	5662	16535	13.70
1990-91	24514	5478	18878	13.37
1991-92	28110	5262	22759	14.64
1992-93	30832	5042	25609	14.23
1993-94	31697	5310	26402	12.87
1994-95	37347	6695	30772	12.38
1995-96	40187	7160	33405	11.07
1996-97	45008	9076	35842	10.51
1997-98	47962	10947	36890	9.75
1998-99	53246	13493	38961	9.20
1999-00	61902	20202	41545	9.12
2000-01	68526	24663	43973	8.62
2001-02	72555	29338	43081	8.02
2002-03	82310	35961	46293	7.73
2003-04	92379	40044	50966	7.65

Figure A.5 Growth of non-POL excise as percent of manufacturing GDP

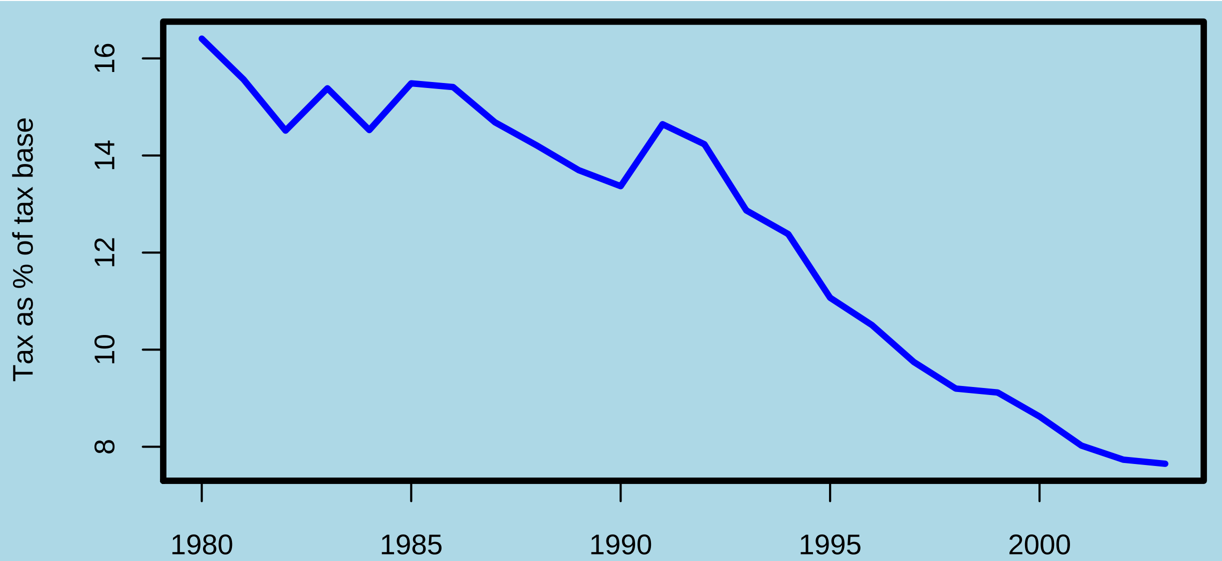
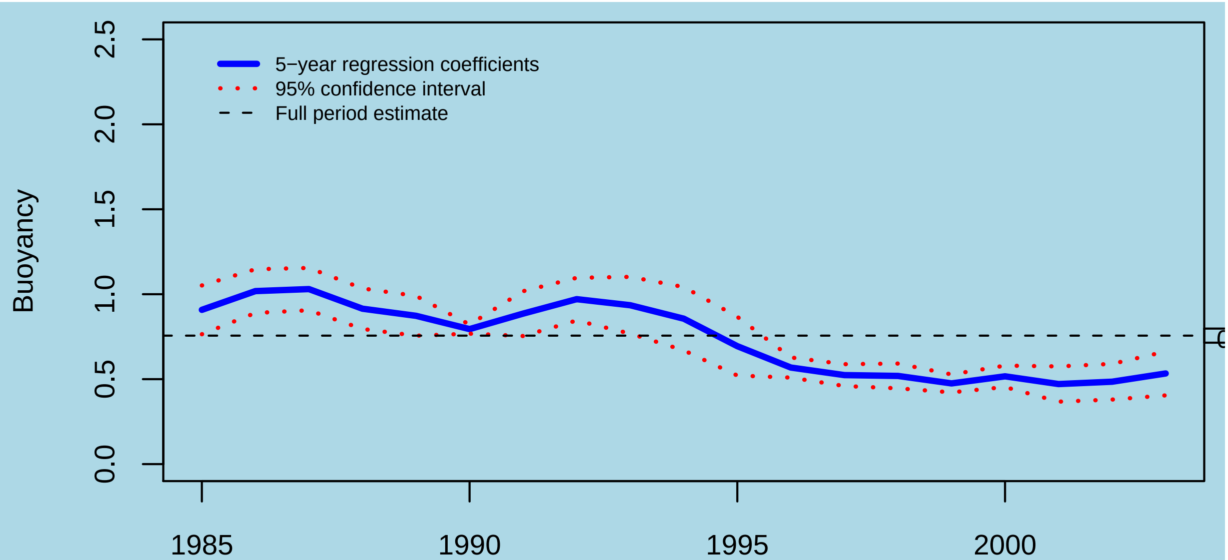


Figure A.6 Five-year rolling window estimates of buoyancy of non-POL excise



regression. In the latest two years, the five-year OLS estimates have been 0.48 and 0.53 respectively.

Table A.5 Summarising buoyancy estimates

	'80-'03	'98-'02	'99-'03
Personal income tax	1.198	1.66	1.47
Corporation tax	1.204	1.63	1.91
Non-POL excise	0.756	0.48	0.53

A.5 Summarising

Table A.5 summarises the results of this analysis. It forms a backdrop for the numerical values used in Section 3.5.

Appendix B

Estimation of revenue potential for a goods and services tax (GST) using firm-level data

This paper was prepared by the Centre for Monitoring Indian Economy (CMIE) at the request of the Ministry of Finance. It constitutes an element of the empirical backdrop for the policy proposals of this report, and is hence presented here as an appendix.

B.1 Questions about revenue potential from the GST

The[1] goal of indirect tax reform is to have a single goods and services tax (GST) that is applied on all firms. This would involve VAT credits running across all kinds of firms in the economy. The use of a single rate would eliminate political lobbying about rates, and eliminate problems of classification. The use of a single rate is neutral to the nature of activity of the firm, thus removing one source of tax-induced distortions in resource allocation.

One major change about the GST concerns the taxation of services production. While the services sector is a substantial fraction of GDP, relatively little is known about the full potential tax revenues from this sector, given the small set of services which have been thus far been brought under the 'service tax'.

Planning the transition into the GST, from the existing mix of excise, CENVAT and the service tax, requires estimation of the revenue potential from GST. This involves two kinds of difficulties. First, there is the problem of estimating the extent to which firms will obtain credits, and the true revenue potential of the GST after all credits are recognised. Second, there is the question of enforcement. While CENVAT chains will undoubtedly lead to improved compliance, there are always questions about the extent to which enforcement will take place.

This paper seeks to bring fresh evidence to bear on this question, and thus assist the process of policy formulation and decision making. It is organised in two

[1]CMIE expresses its gratitude to the several officials from the Central Board of Direct Taxes and the Central Board of Excise and Customs for the gainful insights provided by them during discussions and their comments on the computations used in this paper. Limitations, if any, remain ours.

parts. Section B.2 describes the database, the difficulties in measurement, and the estimation methodology used in this paper. Section B.3 shows estimates for the revenue potential for an economy-wide GST applied to a certain subset of the firms of India.

B.2 Methodology

B.2.1 The CMIE firm-level database

Limited liability firms in India are registered with the Registrar of Companies. All such registered firms are required to file their audited Annual Accounts with the Registrar of Companies every year.

Through an extensive process of developing methodology, systems, and primary information gathering that started in the early 1970s, CMIE has built India's largest firm-level database. This database contains data extracted from the audited Annual Reports of companies (along with several other kinds of data). Manufacturing companies in this database account for more than 90 per cent of the total excise revenues of the Government of India, 70 per cent of the gross value added and 75 per cent of the value of output in the manufacturing (registered) sector of the economy.

Industrial (including manufacturing) and services companies in the CMIE firm-level database together accounted for 75 per cent of the total corporate taxes collected by the Government of India in 2002-03.[2]

The measures of coverage in Table B.1 have been derived from only the top 5,000-odd firms in the CMIE firm-level database. The larger CMIE firm-level database has information for 2,74,446 companies.

The larger database represents a fairly robust sample of the overall corporate sector in India. It reflects the size and the spread of the organised economic entities in the country. Besides the large companies, the database includes hundreds of thousands of small and tiny enterprises. This sample is particularly relevant from the point of estimating the potential for tax collection. The probability of tax compliance from this set of companies collectively is arguably higher than from the unorganised sector. We thus use this set of companies to estimate the potential goods and service tax that can be generated if such a tax is applied uniformly.

B.2.2 Database methodology

The CMIE firm-level database contains financial information extracted from the audited annual accounts in respect of 2,74,446 companies. Information for all these 2,74,446 companies is not available for all the years. CMIE has information for 1,69,965 companies for the year ended March 2000.[3]

In the following years, the number of companies in the database has steadily declined. This decline is the result of a conscious decision to reduce the expenditure for building this database, after having attempted initially to build a comprehensive

[2] The CMIE firm-level database reflects the corporate taxes reported by companies in their profit and loss accounts. The data is not adjusted for provisions for previous years and write-back of excess provisions.

[3] The scope of the CMIE firm-level database expanded substantially in 2000 following an arrangement with the Department of Company Affairs that provided access to records available with the Registrar of Companies.

Table B.1 The CMIE firm-level database : Coverage: 2002-03

(Rs.crore)

Measure	CMIE Sample	Total Value	Official Source	Coverage (%)
Gross value added in regd mfg	1,63,719	2,31,833	CSO	70.6
Value of output in regd mfg	7,97,087	10,77,262	CSO	74.0
Gross savings in corporates	1,04,435	1,76,078	CSO	59.3
Corporate taxes	35,044	46,172	Budget	75.9
Excise duties	92,544	1,06,617	Budget	86.8

Source: *Corporate sector* report, Economic Intelligence Service, CMIE, April 2004

database. Initial efforts had showed that a large number of companies were miniscule in size. Their exclusion was expected to make only an insignificant difference to the larger inferences that could be drawn at the aggregate level.

In 1999-00, 28 per cent of the companies had a sales of less than Rs.1,000. Nearly 37 per cent of the companies had sales of less than Rs.5 lakh. Companies with sales less than Rs.10 lakh in 1999-00 accounted for 51.7 per cent in numbers, but only 0.07 per cent of the total sales. In the light of this distribution, CMIE decided to concentrate its resources on companies that had a sales of at least Rs.10 lakh.

The number of companies for which data is available varies from year to year. One reason for this is that CMIE shifted its attention to the larger companies. We have seen already, that this decision does not significantly adversely affect the aggregate results. Now we look at the other factors that cause the year-to-year variations and consider solutions to overcome these to help us prepare the dataset for our estimation.

Often, companies change their accounting periods. Usually, accounts are prepared for a 12-month period. Conventionally, most of these end with the fiscal year in March. However, sometimes companies do change their accounting period from 12 months in one year to 15 or 18 months in the next. As a result, it is quite possible that in three years a company publishes only two accounts. In such a case, the estimation of aggregates from individual company accounts would miss the company's results for one year and have a correspondingly higher value in the following year because the company reports results for more-than 12 months. We overcome this by annualising all information to 12 months uniformly and by repeating the earlier year's information in the year in which the company's results were missed in the preparation of the panel data.

Companies may merge and cease operations as independent entities. Or they may cease to operate for other reasons and thus may not prepare their annual accounts. Variations are also caused by new entrants into business. These are genuine variations and do not merit any adjustments.

Finally, although CMIE makes its best efforts to procure information, there is no guarantee that it is able to access all possible Annual Reports prepared by companies. Companies are not required by any law to provide information to CMIE. Often, they do not file Annual Reports with the Registrar of Companies. If companies do not provide

Table B.2 The CMIE firm-level database : Size Distribution: 1999-00

Size by Sales (Rupees)	Count (Numbers)	Sales (Rs.crore)	Cumulative Count (%)	Cumulative Sales (%)
Less than 1,000	48,257	0.03	28.4	neg.
1,000 - 10,000	3,392	2	30.4	neg.
10,000 - 50,000	6,527	17	34.2	neg.
50,000 - 100,000	4,445	32	36.8	neg.
100,000 - 500,000	16,070	421	46.3	neg.
5 lakh - 10 lakh	9,180	667	51.7	0.1
10 lakh - 50 lakh	27,863	7,231	68.1	0.5
50 lakh - 1 crore	12,817	9,265	75.6	1.1
1 crore - 50 crore	38,342	2,70,390	98.2	18.2
50 crore - 100 crore	1,375	95,080	99.0	24.2
Above 100 crore	1,697	11,95,537	100.0	100.0

information to the Registrar of Companies and refuse to provide the same to CMIE, we will have gaps in the database. In this paper, imputation is done for these gaps by using the prior year's information, if the prior year's information is available.

After making these adjustments, we arrive at a dataset of 89,445 firms that had their accounts ending sometime during the period April 2002 to June 2003 (mostly ending in March 2003). If a company did not report (or if we did not have) accounts for a period ending in this range, we use the older information available with us, but subject to the condition that such information is not older than for an accounting period ending September 2001. Stated differently, for these 89,445 firms, the CMIE firm-level database had some audited accounts data available for a period ending between September 2001 and June 2003 and, we have used the latest available data in this period.

It is this set of 89,445 companies[4] that we use to estimate the potential goods and service tax that can be generated. These are the larger and well-organised entities that can be expected to pay a tax levied upon them.

B.2.3 Services sector coverage in the database

The services sector presents qualitatively different problems in obtaining compliance. About two-thirds of the manufacturing activity is in the organised sector. It is easier to deal with this organised industrial activity than with the myriad small and tiny enterprises in the unorganised sector. "Organised" can be construed more tangibly in the case of manufacturing firms – these are registered under the Factories Act.

There is no similar legislation by which all

[4]Strictly, these are not only companies as they include several entities that are not registered as companies. For example, Indian Farmers Fertiliser Co-op is a cooperative and is not registered as a company. But, the CMIE firm-level database includes it as it does several other cooperatives. Similarly, State Bank of India is not registered as a company, like say, UTI Bank Ltd is. Nevertheless, the CMIE firm-level database would include a State Bank of India. The objective of the CMIE firm-level database is to create a database of all possible business entities, independent of the legal structure of the entity.

services sector firms can be enumerated or classified. Regulation is limited to banks and a few other services.

A larger proportion of the enterprises in the services sector are unorganised. Wholesale and retail trade is characterised by a very large number of business entities that are proprietory and household enterprises. Similarly, there are a number of small restaurants, second-tier or third-tier intermediaries in the financial sector, professional services, etc. that could be classified as unorganised. The diverse nature of services activities and the larger proportion of firms being in the unorganised sector makes the task of estimating the potential revenue from the levy of a service task daunting.

It can be assumed that the organised institutional entities in the services sector can be persuaded to comply with the levy of a service tax. It would thus be useful to estimate the size of the large and medium firms in the services sector to derive a realistic estimate of the potential revenue that can be generated from the services sector.

Firm–level information in the services sector has become stronger in the past one decade or so, compared to the situation earlier. There are three reasons for this. First, several departmental undertakings of the government have been corporatised. For example, the Department of Telecommunications is now Bharat Sanchar Nigam Ltd. Secondly, several activities that were largely outside the purview of the corporate world, such as hospitals, entertainment, courier services, etc have joined the organised business domain and therefore do publish publicly accessible information. Thirdly, the exceptional growth of the services sector has attracted substantial investments in the organised sector. The best example of this is the private sector investment in the telecommunications sector.

The CMIE firm-level database contains financial information extracted from the audited annual accounts in respect of 1,46,976 companies that are engaged essentially in services activities. Information on all these 1,46,976 companies is not available for all the years. CMIE has information for 1,04,625 companies for the year ended March 2000. In the following years, the number of companies in the database declines steadily since CMIE decided to concentrate its effort only the larger companies. It was anticipated that the exclusion of companies of sales less than Rs.10 lakh would make an insignificant impact upon the inferences drawn at the aggregate level.

31 per cent of the 1,04,625 companies in 1999–00 reported sales of less than a thousand rupees. A third of the companies had sales of less than ten thousand rupees. Most of the very small companies were investment and trading companies.

For the year 2001–02, CMIE compiled statistics essentially on companies whose sales size was greater than Rs.10 lakh per annum. The number of companies covered by the CMIE firm-level database dropped by half as a result of the reduced outlays for this activity. The coverage, in terms of the proportion of the total gross value added in the services sector dropped insignificantly – from 22.6 per cent in 1999-00 to 22.2 per cent in 2001-02.

The 52,456 companies for which we have compiled the statistics for 2001–02 are thus likely to reflect the size of the activities of the organised services sector almost as well as the entire set of 1.4 lakh companies. The set of 14,921 companies for which we have data

Table B.3 CMIE firm-level database : Coverage of Services Sector

Year	Count	Sales	Gross Value Added	
				% of total
	(Numbers)	(Rs.crore)	(Rs.crore)	(services GVA)
1999–00	1,04,625	5,23,208	1,91,032	22.6
2000–01	95,559	6,21,486	2,09,294	22.5
2001–02	52,456	6,06,317	2,28,784	22.2
2002–03	14,921	4,99,015	2,21,685	19.4

Note: Only companies with sales greater than Rs.10 lakh covered in 2001-02 and 2002-03. Coverage in 2002–03 is incomplete, as work was in progress.

for 2002–03 reflects the incomplete database for the year. Annual Accounts for companies for this year are still flowing in and many of those that have been received by us are still being processed. Nevertheless, a good proportion of the larger companies have been captured in the database.

A dataset of 52,304 companies was prepared for the purpose of our computations. These had their accounts ending sometime during the period April 2002 to June 2003 (mostly ending March 2003). Or if there were companies for which data was not available for this period, then we have used the older information available for these, subject to the condition that the information is not older than for an accounting period ended in September 2001. This set of 52,304 companies is used to estimate the potential service tax that can be generated. These are the larger and well organised enterprises that can be expected to pay a tax levied upon them.

This set of 52,304 companies covers 22.1 per cent of the gross value added in the services sector in India. Firm-level databases do not cover public administration and defence sectors. These account for 12.7 per cent of the gross value added in the services sector as a whole. If we exclude this sector, then the CMIE firm-level database has a coverage of 25.3 per cent.

Intriguingly, the CMIE firm-level database provides a higher estimate of the gross value added in the banking and insurance sector than the National Accounts Statistics. This is likely because the CMIE firm-level database does not cover the State Finance Corporations, State Industrial Development Corporations and the Regional Rural Banks – all which are likely to be grossly loss-making and possibly contributing negatively to the gross value addition.

Nevertheless, the coverage of over-100 per cent is intriguing. This is because we have had to drop a number of small investment companies and smaller non-banking financial companies from our sample because of the need for more detailed information in respect of finance companies than was readily available for such small finance companies in the CMIE firm-level database. The problem arises because the payment of interest by banks is lower than the interest received by banks and, if we net the two (like we do for all other enterprises), to derive the value addition, banks would reflect net negative interest payments. This would be misleading. The National Accounts Statistics imputes income equivalent to interest and dividend receipts of banking and financial enterprises net of interest paid to depositors. We have

Table B.4 Sub-sectors of the services sector: CMIE firm-level database compared with NAS, 2002–03

(Rs.crore)

	NAS data	Estimates using firm -level data	Coverage (per cent)	Firms (Nos.)
Trade	2,99,059	16,965	5.7	15,375
Hotels & Restaurants	22,935	2,484	10.8	1,579
Railways	21,551			
Transport by other means	1,14,889	12,869	11.2	2,247
Storage	1,331	988	74.2	574
Communication	35,620	28,682	80.5	483
Banking & insurance	1,58,279	1,61,450	102.0	13,369
Real estate, ownership of dwellings, bus. services	1,52,079	23,870	15.7	10,904
Public admin & defence	1,45,406			
Other services	1,89,898	4,791	2.5	7,773
Total	11,41,047	2,52,099	22.1	52,304

followed a similar approach in computing interest income of banks. We deduct interest payments made to depositors from the income earned by finance companies by lending and by investments in securities. It is quite likely that the inclusion of these smaller finance companies would have raised the gross value added in this sector a little more.

The dataset has a fairly good coverage of the communications sector. The gross value added covered is more than 80 per cent of the estimates in the National Accounts. Storage is similarly well covered with over 70 per cent. In other cases, the coverage in the firm-level database is much lower – ranging between 2.5 and 15.5 per cent.

In comparing the coverage of the CMIE firm-level database with the National Accounts, firms engaged in software development and in IT-enabled services are mapped to the broad heading "Real estate, ownership of dwellings & business consultancy".

Half of the revenue base in the CMIE firm-level database lies in commercial banks. Financial institutions, NBFCs, housing finance companies, investment service companies and other financial service companies account for another 17 per cent. Thus, the financial sector would account for nearly two-thirds of the potential revenue.

Telecom companies and trading companies follow in importance, after the financial sector. The firm-level database does not include the Indian Railways. However, the other transport service companies could yield more than a thousand crore. Of this air transport companies would provide nearly half the amount.

The classification of services presented in official publications on NAS are at broad aggregate levels. These offer little insight into the nature of production of the services sector. Table B.5 shows greater detail, using a classification system developed at CMIE, showing the number of firms and the size of economic activity taking place in various kinds of services. This evidence could be

Table B.5 Industry classification of services firms in the CMIE firm-level database (2002-03)

(Rs.crore)

	Firms (Nos.)	Sales	Gross Value Added	Net Exports
Financial Services	13369	307125	161450	665
Banking services	87	164954	119176	0
Financial institutions	28	24668	11824	-310
Non-banking financial cos. (NBFCs)	561	7089	5090	431
Housing finance services	22	4764	2772	-261
Investment services	10355	15206	5925	136
Other financial services	2316	90444	16663	668
Hotels & tourism	1579	5172	2484	1201
Hotels & restaurants	1533	4909	2353	1098
Tourism	46	263	131	103
Recreational services	660	3458	963	150
Production of TV serials/films	240	2105	690	181
Broadcasting/distribution of TV serials/films	22	95	4	-2
Processing of films/colour labs, etc.	11	145	80	-3
Pre-recorded and recorded cassettes	52	229	-22	-7
Amusement parks/entertainment centres/theatres	117	477	74	-5
Other recreational services	218	407	137	-14
Health services	914	2186	873	-32
Trading	15375	187075	16965	-9772
Transport services	2247	37558	12869	-114
Road transport	305	4454	959	-3
Railway transport	4	254	213	-628
Air transport	41	15971	5587	-552
Shipping	260	6755	3419	770
Transport support services	1637	10125	2691	300
Communication services	483	48752	28682	-947
Telecommunication services	407	47760	28432	-937
Telephone services	11	39900	26670	987
Other telecommunication services	396	7860	1762	-1924
Courier services	76	992	249	-9
Misc. services	17677	62487	27813	24817
Commercial complexes	3164	2802	738	41
Storage & distribution	574	2588	988	-274
Business consultancy	6362	11466	4805	3042
Misc. other services	6199	13512	2955	1266
ITES	59	849	534	509
Computer software	1319	31270	17793	20233
Total	52304	653813	252099	15968

useful in planning administrative procedures.

B.2.4 Issues in using this database for GST estimation

In this paper, we harness this economy-wide database about the firms of India in order to estimate the revenue potential from the GST. A 10 per cent GST is estimated by us to yield GST revenues which are one-tenth of the value added of the firms as seen in this database. We believe that these estimates are conservative. There are two key characteristics of the imputation process adopted by us that lead to conservative estimates. These are:

Problem of credits When firms are charged a GST on their revenue, there is the question about how much credit they will obtain, reflecting the tax payments embedded in the inputs they have purchased. We address this question by focusing on value added, as observed in the accounting data. We treat the tax base as the value added of the firm. This is a conservative assumption, in the sense that not all inputs purchased by the firm may involve tax credits. In practice, collections are likely to be somewhat higher than those portrayed in this paper.

Questions of enforcement The GST would be applied to all production in the economy, including production by limited liability companies, cooperatives, proprieterships, non-profit firms, etc. We focus on a subset of this universe: limited liability companies, and some other firms for which data is available. This is a conservative estimate, in the sense that the GST will yield revenues from many organisations which are not covered in this subset.

B.3 Estimating potential GST revenues using firm-level data

We use two indicators to estimate the potential revenue that can be expected by the levy of a goods and service tax. These are, sales and gross value added. Sales is a robust number compared to the gross value added, as it is directly observed in the accounts of the company. However, sales obviously overestimates the potential tax revenues from a value added tax.

Estimation of the gross value added from the Annual Accounts of companies is somewhat difficult. We estimate gross value added by adding the payments made to the factors of production. We thus take the sum of wages, interest payments, rent, profits and depreciation for the year. However, companies do not account for rent if they own the premises. And, depreciation charges are not uniformly applied.

We make no adjustments for these. It is assumed that rent that does not get reported shows up as profits and nevertheless gets captured in the GVA estimate. The argument holds for any under-reporting of depreciation in the accounts of companies. We also need to make adjustment for interest income of financial intermediaries. This is explained by us in Section B.2.3.

It is likely that the gross value added from firm level data would underestimate the potential tax revenues. Using the GVA as the base from which the GST is imputed implies that firms would claim credit for tax payments embedded in all inputs purchased. This is a conservative assumption.

Assuming that non-finance companies would claim setoffs against taxes included in interest paments made by them, we compute the tax potential by deducting interest payments from the GVA. Further, assuming that companies would get set-offs against net exports, we also deduct net exports from sales and gross value added in estimating the potential service tax revenue that can be

Table B.6 Summary statistics about CMIE firm-level database : 2002-03

(Rs.crore)

Industry	Firms (Nos.)	Sales	Gross Value Added	Net Exports	GVA less Interest Payments
Manufacturing	32,236	11,35,588	1,87,417	-54,929	1,44,428
Of which: POL	43	2,65,721	23,424	-66,445	21,180
: Non-POL	32,193	8,69,867	1,63,993	11,516	1,23,248
Mining	931	73,435	37,990	-6,519	36,346
Electricity	183	68,755	27,723	-4,566	22,179
Construction	3,791	24,531	5,717	224	4,230
Services	52,304	6,53,814	2,52,098	15,969	2,32,929
Of which:Financial Serv.	13,369	3,07,125	1,61,450	665	1,60,785
Total	89,445	19,56,123	5,10,045	-49,821	4,40,112

generated from firms in the services sectors. The net exports figures are also derived from the Annual Audited Accounts of the companies used in this study.

Table B.6 presents a summary of the aggregates generated by using the audited annual accounts of 89,445 firms for the year 2002-03. Although this is the largest compilation of aggregates based on firm-level data, there are some limitations in coverage. These again point to the conservativeness of the ultimate estimates that we derive.

Nearly half the value addition in these firms is generated from the services sector. However, this excludes the Indian Railways. This administratively easy potential source of tax revenue is completely missing in the computations because the Indian Railways does not publish accounts in the traditional sense of the term. Transport by other means is also under-represented in our computations. The estimates reflect essentially, the airlines. However, the road transport industry is grossly undercovered because of paucity of data.

Firms engaged in construction activities are large and reasonably organised although, most of these are not registered as companies. These are also under-represented in our computations.

Table B.7 presents estimates of the GST that can be collected if the tax is imposed on sales or on sales net of net exports. These are the upper bounds of the potential GST that can be generated from these firms.

In making estimates of the potential GST with the GVA as the base, we introduce an additional element of the setoff that non-finance companies may claim against interest payments made by them. Besides, we deal with the petroleum sector differently. Instead of using the GVA, we use the sales as the base. We have assumed that the petroleum sector would continue to attract excise on its sales and not a tax based on the GVA. Table B.8 presents estimates based on the GVA and Table B.9 presents estimates based on GVA net of net interest payments. In both tables, we show separately, the estimates net of net exports and again, in both tables, POL estimates are based on sales and not on GVA.

All the estimates presented above relate to the year 2002-03. The full dataset for 2003-04 was under preparation at the time of

Table B.7 Estimates of potential revenue from a uniform GST based on Sales in 2002-03

(Rs.crore)

	Tax on Sales @			Tax on Sales net of net exports @		
	8%	12%	16%	8%	12%	16%
Manufacturing	90,847	1,36,271	1,81,694	95,241	1,42,862	1,90,483
Of which: POL	21,258	31,887	42,515	26,573	39,860	53,147
: Non-POL	69,589	1,04,384	1,39,179	68,668	1,03,002	1,37,336
Mining	5,875	8,812	11,750	6,396	9,594	12,793
Electricity	5,500	8,251	11,001	5,866	8,799	11,731
Construction	1,962	2,944	3,925	1,945	2,917	3,889
Services	52,305	78,458	1,04,610	51,028	76,541	1,02,055
Total	1,56,490	2,34,735	3,12,980	1,60,476	2,40,713	3,20,951

Table B.8 Estimates of potential revenue from a uniform GST based on GVA in 2002-03

(Rs.crore)

	Tax on GVA @			Tax on GVA net of net exports @		
	8%	12%	16%	8%	12%	16%
Manufacturing	34,377	51,566	68,754	38,771	58,157	77,543
Of which: POL	21,258	31,887	42,515	26,573	39,860	53,147
: Non-POL	13,119	19,679	26,239	12,198	18,297	24,396
Mining	3,039	4,559	6,078	3,561	5,341	7,121
Electricity	2,218	3,327	4,436	2,583	3,875	5,166
Construction	457	686	915	439	659	879
Services	20,168	30,252	40,336	18,890	28,335	37,781
Total	60,259	90,390	1,20,519	64,244	96,367	1,28,490

Note: POL estimations are based on sales and not GVA

Table B.9 Estimates of potential revenue from a uniform GST based on GVA net of interest payments in 2002-03

(Rs.crore)

	Tax on GVA net of interest @			Tax on GVA net of net exports & interest @		
	8%	12%	16%	8%	12%	16%
Manufacturing	31,118	46,676	62,235	35,512	53,268	71,024
Of which: POL	21,258	31,887	42,515	26,573	39,860	53,147
: Non-POL	9,860	14,790	19,720	8,939	13,408	17,877
Mining	2,908	4,362	5,815	3,429	5,144	6,858
Electricity	1,774	2,661	3,549	2,140	3,209	4,279
Construction	338	508	677	320	481	641
Services	18,634	27,951	37,269	17,357	26,035	34,714
Total	54,772	82,158	1,09,544	58,758	88,137	1,17,516

Note: POL estimations are based on sales and not GVA

these computations. However, it is possible to make estimates for 2003-04 based on the sales growth observed in the sales of listed companies. As per SEBI regulations, listed companies are required to release their quarterly results within one month of the end of the quarter. We see from these results that sales grew by about 12 per cent during the year. Using the estimates made above and assuming that the overall sales growth of all companies grew by ten per cent, the potential GST that can be generated from firms that publish their audited annual accounts can be easily computed.

If a uniform GST of eight per cent is levied on the GVA net of net exports and net of interest payments on all firms, then the potential GST that could be generated in 2003-04 would be Rs.64,634 crore. If GST is 12 per cent this rises to Rs.96,951 crore and at 16 per cent it rises to Rs.129,267 crore. These are the lower bounds of the potential revenue, given the extent to which value added in the country takes place in firms outside the CMIE firm-level database.

B.4 Determining a minimum size for levying a GST

The distribution of the gross value added amongst firms in the CMIE firm-level database is skewed. A few firms account for most of the gross value added while a large number contribute negligibly to the overall GVA[5]. We find that a little over half the firms account for 99.7 per cent of the total GVA. More precisely, firms that reported a gross value added of Rs.20 lakh or more account for 51.7 per cent of all GVA-positive firms and these account for 99.7 per cent of the total GVA reported by GVA-positive firms.

Administratively, it would be far more efficient to concentrate on these relatively larger firms. Every VAT implementation in the world uses a lower size threshold below which firms are exempted from VAT payment. Figure B.1 shows empirical evidence for firms with positive value added. Alternative size thresholds are placed on the x axis (in log scale). For each candidate value of the minimum size threshold, two values are shown on the y axis: (a) The fraction of total value added that is captured in the tax net under this threshold, and (b) the fraction of firms that fall above this threshold.

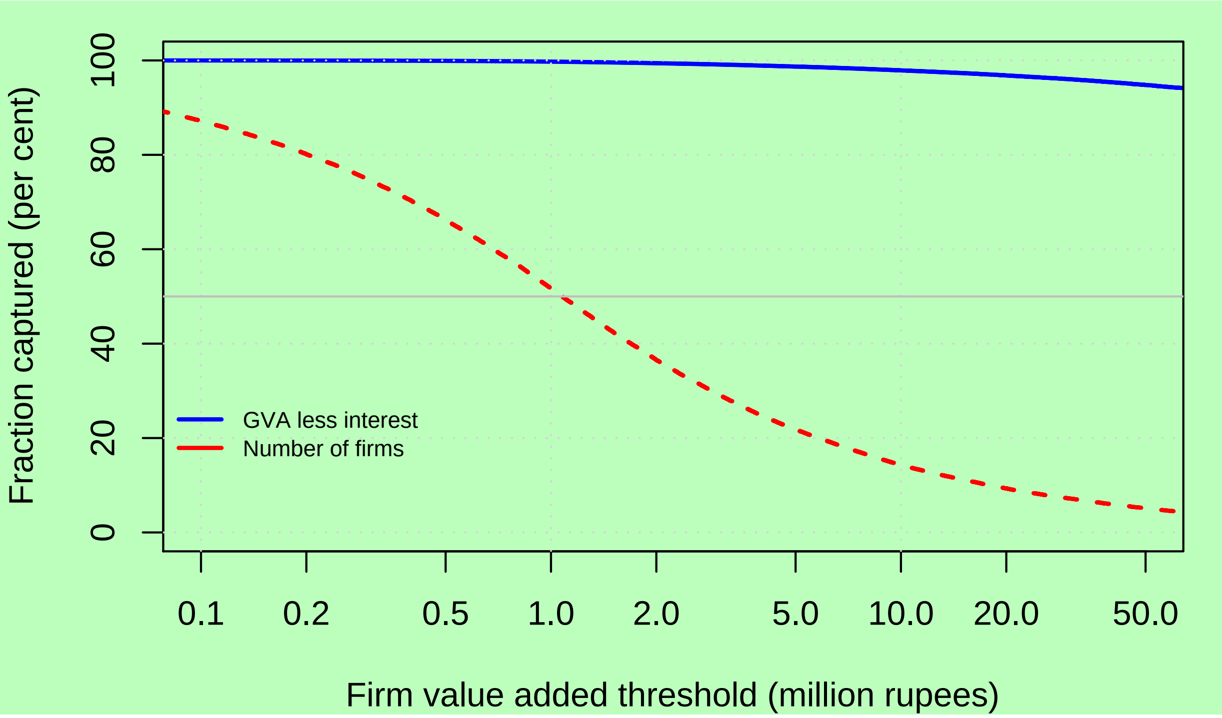
The results show that roughly half of the firms have a value added of below Rs.10 lakh. This suggests that the cost of tax administration would come down by roughly half, by using such a threshold. At the same time, roughly 100% of the value added lies above this threshold. Hence, it appears useful to use Rs.10 lakh of value added as the minimum size threshold; this seems to be associated with a negligible revenue loss, and a halving of the cost to the government.

In practice, it would be far more convenient to use a measure such as sales instead of GVA. As a broad average, in the CMIE firm-level database it is found that sales is usually six times the GVA. This approximation can be used to convert GVA cutoffs into turnover cutoffs.

These estimates should be viewed with caution owing to the extent to which firms self-select themselves into organisational structures. Larger firms are more likely to incorporate. Hence, estimates about size cutoffs based on the CMIE firm-level database are likely to be biased upwards.

[5] Unlike measures such as sales or assets, the GVA can take a negative value. Loss making firms can report a negative GVA. Thus, some firms also contribute negatively to the overall GVA. We find that 22 per cent of the firms reported a non-positive GVA.

Figure B.1 Coverage of firms obtained under alternative size thresholds



Appendix C

The FRBM Act and associated Rules

C.1 FRBM ACT, 2003

सत्यमेव जयते

The Gazette of India

Extraordinary

Ministry of Law and Justice

(Legislative Department)

New Delhi, the 26th August, 2003,/Bhadra 4, 1925 (Sakes)

The following Act of Parliament received the assent of the President on the 26 August 2003, and is hereby published for general information:-

The Fiscal Responsibility and Budget Management ACT, 2003

No. 39 of 2003

[26th August, 2003]

An Act to provide for the responsibility of the Central Government to ensure inter-generational equity in fiscal management and long-term macro-economic stability by achieving sufficient revenue surplus and removing fiscal impediments in the effective conduct of monetary policy and pi prudential debt management consistent with fiscal sustainability through limits on the Central Government borrowings, debt and deficits, greater transparency in fiscal operations of the Central Government and conducting fiscal policy in a medium-term framework and for matters connected there with or incidental thereto.

Be it enacted by Parliament in the Fifty-fourth Year of the Republic of India as follows:-

1. (1) This Act may be called the Fiscal Responsibility and Budget Management Act, 2003.

(2) It extends to the whole of India.

(3) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint in this behalf.

2. In this Act, unless the context otherwise requires:-

(a) **fiscal deficit** means the excess of total disbursements, from the Consolidated Fund of India, excluding repayment of debt, over total receipts into the Fund (excluding the debt receipts), during a financial year,

(b) **fiscal indicators** means the measures such as numerical ceilings and proportions to gross domestic product, as may be prescribed, for evaluation of the fiscal position of the Central Government;

(c) **prescribed** means prescribed by rules made under this Act;

(d) **Reserve Bank** means the Reserve Bank of India constituted under sub-section (1) of section 3 of the Reserve Bank of India Act, 1934;

(e) **revenue deficit** means the difference between revenue expenditure and revenue receipts which indicates increase in liabilities of the Central Government without corresponding increase in assets of that Government;

(f) **total liabilities** means the liabilities under the Consolidated Fund of India and the public account of India.

3. (1) The Central Government shall lay in each financial year before both Houses of Parliament the following statements of fiscal policy along with the annual financial statement and demands for grants, namely:-

(a) the Medium-term Fiscal Policy Statement;

(b) the Fiscal Policy Strategy Statement;

(c) the Macro,-economic Framework Statement.

(2) The Medium-term Fiscal Policy Statement shall set forth a three-year rolling target for prescribed fiscal indicators with specification of underlying assumptions.

(3) In particular, and without prejudice to the provisions contained in sub-section (2), the Medium-term Fiscal Policy Statement shall include an assessment of sustainability relating to

(i) the balance between revenue receipts and revenue expenditures;

(ii) the use of capital receipts including market borrowings for generating productive assets.

(4) The Fiscal Policy Strategy Statement shall, *inter alia*, contain

(a) the policies of the Central Government for the ensuing financial year relating to taxation, expenditure, market borrowings and other liabilities, lending and investments, pricing of administered goods and services, securities and description of other activities such as underwriting and guarantees which have potential budgetary implications;

(b) the strategic priorities of the Central Government for the ensuing financial year in the fiscal area;

(c) the key fiscal measures and rationale for any major deviation in fiscal measures pertaining to taxation, subsidy, expenditure, administered pricing and borrowings;

(d) an evaluation as to how the current policies of the Central Government are in conformity with the fiscal management principles set out in section 4 and the objectives set out in the Medium-term Fiscal Policy Statement.

(5) The Macro-economic Framework Statement shall contain an assessment of the growth prospects of the economy with specification of underlying assumptions

(6) In particular, and without prejudice to the generality of the foregoing provisions,the Macro-economic Framework Statement shall contain an assessment relating to-

(a) the growth in the gross domestic product;

(b) the fiscal balance of the Union Government as reflected in the revenue balance and gross fiscal balance;

(c) the external sector balance of the economy as reflected in the current account balance of the balance of payments.

(7) The Medium-term Fiscal Policy Statement, the Fiscal Policy Strategy Statement and the Macro-economic Framework Statement referred to in sub-section (1) shall be in such form as may be prescribed.

4. (1) The Central Government shall take appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by the 31 March, 2008 and thereafter build up adequate revenue surplus.

(2) The Central Government shall, by rules made by it, specify-

(a) the annual targets for reduction of fiscal deficit and revenue deficit during the period beginning with the commencement of this Act and ending on the 31 March, 2008;

(b) the annual targets of assuming contingent liabilities in the form of guarantees and the total liabilities as a percentage of gross domestic product:

Provided that the revenue deficit and fiscal deficit may exceed such targets due to ground or grounds of national security or national calamity or such other exceptional grounds as the Central Government may specify:

Provided further that the ground or grounds specified in the first proviso shall be placed before both Houses of Parliament, as soon as may be, after such deficit amount exceed the aforesaid targets.

5. (1) The Central Government shall not borrow from the Reserve Bank.

(2) Notwithstanding anything contained in sub-section (1), the Central Government may borrow from the Reserve Bank by way of advances to meet temporary excess of cash disbursement over cash receipts during

any financial year in accordance with the agreements which may be entered into by that Government with the Reserve Bank:

Provided that any advances made by the Reserve Bank to meet temporary excess cash disbursement over cash receipts in any financial year shall be repayable in accordance with the provisions contained in sub-section (5) of section 17 of the Reserve Bank of India Act, 1934.

(3) Notwithstanding anything contained in sub-section (1), the Reserve Bank may subscribe to the primary issues of the Central Government securities during the financial year beginning on the 1^{th} day of April, 2003 and subsequent two financial years:

Provided that the Reserve Bank may subscribe, on or after the period specified in this sub-section, to the primary issues of the Central Government securities due to ground or grounds specified in the first provision to sub-section (2) of section 4.

(4) Notwithstanding anything contained in sub-section (1), the Reserve Bank may buy and sell the Central Government securities in the secondary market.

6. (1) The Central Government shall take suitable measures to ensure greater transparency in its fiscal operations in the public interest and minimise as far as practicable, secrecy in the preparation of the annual financial statement and demands for grants.

(2) In particular, and without prejudice to the generality of the foregoing provision; the Central Government shall, at the time of presentation of annual financial statement and demands for grants, make such disclosures and in such form as may be prescribed.

7. (1) The Minister-in-charge of the Ministry of Finance shall review, every quarter; the trends in receipts and expenditure in relation to the budget and place before both Houses of Parliament the outcome of such reviews.

(2) Whenever there is either shortfall in revenue or excess of expenditure over the pre-specified levels mentioned in the Fiscal Policy Strategy Statement and the rules made under this Act during any period in a financial year, the Central Government shall take appropriate measures for increasing revenue or for reducing the expenditure (including curtailing of the sums authorised to be paid and applied from and out of the Consolidated Fund of India under any Act so as to provide for the appropriation of such sums):

Provided that nothing in this sub-section shall apply to the expenditure charged on the Consolidated Fund of India under clause (3) of article 112 of the Constitution or to any other expenditure which is required to be incurred under any agreement or contract or such other expenditure which cannot be postponed or curtailed.

(3) (a) Except as provided under this Act, no deviation in meeting the obligations cast on the Central Government under this Act, shall be permissible without approval of Parliament.

(b) Where owing to unforeseen circumstances, any deviation is made in meeting the obligations cast on the Central Government under this Act, the Minister-in-charge of the Ministry of Finance shall make a statement in both Houses of Parliament explaining

(i) any deviation in meeting the obligations cast on the Central Government under this Act;

(ii) whether such deviation is substantial and relates to the actual or the potential budgetary outcomes; and

(iii) the remedial measures the Central Government proposes to take.

8. (1) The Central Government may, by notification in the Official Gazette, make rules for carrying out the provisions of this Act.

(2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely:-

(a) the annual targets to be specified under sub-section (2) of section 4;

(b) the fiscal indicators to be prescribed for the purpose of sub-section (2) of section 3;

(c) the forms of the Medium-term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macro-economic Frame Work Statement referred to in sub-section (7) of section 3;

(d) the disclosures and form in which such disclosures shall be made under sub-section (2) of section 6;

(e) any other matter which is required to be, or may be, prescribed.

9. Every rule made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which tray be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.

10. No suit, prosecution or other legal proceedings shall lie against the Central Government or any officer of the Central Government for anything which is in good faith done or intended to be done under this Act or the rules made thereunder.

11. No civil court shall have jurisdiction to question the legality of any action taken by, or any decision of, the Central Government, under this Act.

12. The provisions of this Act shall be in addition to, and not in derogation of the provisions of any other law for the time being in force.

13. (1) If any difficulty arises in giving erect to the provisions of this Act, the Central Government may, by order published in the Official Gazette, make such provisions not inconsistent with the provisions of this Act as may appear to be necessary for removing the difficulty:

Provided that no order shall be made under this section after the expiry of two years from the commencement of this Act.

(2) Every order made under this section shall be laid, as soon as may be after it is made, before each House of Parliament.

C.2 FRBM Rules, 2004

Notification

New Delhi, the 2nd July, 2004

G.S.R. 396(E). - In exercise of the powers conferred by section 8 of the Fiscal Responsibility and Budget Management Act, 2003 (39 of 2003), the Central Government hereby makes the following rules, namely:-

1. Short title and commencement

(1) These rules may be called the Fiscal Responsibility and Budget Management Rules, 2004.

(2) They shall come into force on the 5**th** day of July, 2004.

2. Definitions - In these rules, unless the context otherwise requires,

(a) **Act** means the Fiscal Responsibility and Budget Management Act, 2003 (39 of 2003);

(b) **Form** means a form appended to these rules;

(c) **GOP** means gross domestic product at current prices;

(d) **section** means a section of the Act;

(e) words and expressions used herein but not defined and defined in the Act shall have the meanings respectively assigned to them in the Act.

3. Annual targets

(1) In order to achieve the target of revenue deficit as set out in 'sub-section (1) of section 4, by the 31^{th} day of March, 2008, the Central Government shall reduce such deficit by an amount equivalent to 0.5 per cent or more of the GDP at the end of each financial year, beginning with the financial year 2004–2005.

(2) The Central Government shall reduce the fiscal deficit by an amount equivalent to 0.3 per cent or more of the GDP at the end of each financial year beginning with the financial year 2004–2005, so that fiscal deficit is brought down to not more than 3 per cent of GDP at the end of 31^{st} day of March, 2008.

(3) The Central Government shall not give guarantees aggregating to an amount exceeding 0.5 per cent of the GDP in any financial year beginning with the financial year 2004–2005.

(4) The Central Government shall not assume additional liabilities (including external debt at current exchange rate) in excess of 9 per cent of GDP for the financial year 2004-2005 and in each subsequent financial year, the limit of 9 per cent of GDP shall be progressively reduced by at least one percentage point of GDP.

4. Medium Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macro Economic Framework Statement -

The Medium Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macro-Economic Framework Statement required to be laid before both Houses of Parliament by the Central Government along with the annual financial statement and demands for grants shall be in Forms F-1, F-2 and F-3 respectively.

5. Fiscal Indicators -

(1) In the Medium Term Fiscal Policy Statement, three year rolling targets in respect of the following, fiscal indicators shall be

as given in Form F-1, namely:-

(i) revenue deficit as a percentage of GDP;

(ii) fiscal deficit as a percentage of GDP;

(iii) tax revenue as a percentage of GDP; and

(iv) total outstanding liabilities of the Central Government as a percentage of GDP.

(2) The Fiscal Policy Strategy Statement in Form F-2 shall also contain the intra-year benchmarks for assessing the trends in receipts and expenditure relating to annual targets and Budget Estimates.

6. Disclosures -

(1) In order to ensure greater transparency in its fiscal operation in the public interest, the Central Government shall, at the time of presenting the annual financial statement and demands for grants, make disclosures of the following:-

(a) any significant change in accounting standards, policies and practices affecting or likely to affect the computation of prescribed fiscal indicators.

(b) statements of receivables and guarantees in Forms D-1 to D-3.

(c) a statement of assets in Form D-4.

(2) The provisions of sub-rule (1) shall be complied with not later than with the presentation of the annual financial statement and demands for grants for the financial.year 2006-2007.

7. Measures to enforce compliance
In case the outcome of the quarterly review of trends in receipts and expenditure, made under sub-section (1) of section 7, at the end of second quarter of any financial year beginning with the financial year 2004-2005 shows that -

(i) the total non-debt receipts are less than 40 per cent of Budget Estimates for that year; or

(ii) the fiscal deficit is higher than 45 per cent of the Budget Estimates for that year; or

(iii) the revenue deficit is higher than 45 per cent of the Budget Estimates for that year,

then, -

(a) as required under sub-section (2) of that section, the Central Government shall take appropriate corrective measures; and

(b) as required under sub-section (3) of that section, the Minister-in-charge of the Ministry of Finance shall make a statement in both Houses of Parliament during the session immediately following the end of the second quarter detailing the corrective measures taken, the manner in which any supplementary demands for grants are proposed to be financed and the prospects for the fiscal deficit of that financial year.

Form F-1 [See rule 4]

MEDIUM TERM FISCAL POLICY STATEMENT

A. Fiscal Indicators – Rolling Targets

	Current Year Revised Estimates	Ensuing year Target: Budget Estimates Y	Targets for next Two years Y+1	Y+2
1. Revenue Deficit as percentage of GDP				
2. Fiscal Deficit as percentage of GDP				
3. Tax Revenue as percentage of GDP				
4. Total Outstanding Liabilities as percentage of GDP				

B. Assumptions underlying the Fiscal Indicators -

1. Revenue receipts

(a) Tax-revenue - Sectoral and GDP growth rates

(b) Non-tax-revenue - Policy stance

(c) Devolution to States - Finance Commission

2. Capital receipts - Debt stock, repayment, fresh loans and policy stance

(a) Recovery of loans

(b) Other receipts

(c) Borrowings - Public Debt and Other Liabilities

3. Total expenditure - Policy Stance -

(a) Revenue account

(i) Interest payments

(ii) Major subsidies

(iii) Others

(b) Capital account

(i) Loans and advances

(ii) Capital outlay

4. GDP Growth

C. Assessment of sustainability relating to-

(i) The balance between revenue receipts and revenue expenditure. The Medium Term Fiscal Policy Statement may specify the tax-GDP ratio for the current year and subsequent two years with an assessment of the changes . required for achieving it. It may discuss the non-tax revenues and the. policies concerning the same. An assessment of the capital receipts may be made, including the borrowings and other liabilities, as per policies spelt out. The statement may also give projections for GDP and discuss it on the basis of assumptions underlying the indicators. Expenditure on revenue account, both plan and non-plan, may also be made with particular emphasis on the measures proposed to meet the overall objectives.

(ii) The use of capital receipts including market borrowings for gene rating productive assets. The Medium Term Policy Statement may specify the proposed use of capital receipts for generating productive assets in different categories. It may also spell out proposed changes among these categories and discuss it in terms of the overall policy of the Government in achieving the national objective.

Form F - 2 [See rule 4]

FISCAL POLICY STRATEGY STATEMENT

A: Fiscal Policy Overview: [This paragraph will present an overview of the fiscal policy currently in vogue.]

B: Fiscal policy for the ensuing financial year: [This paragraph shall have five sub-paragraphs dealing with -

(1) Tax Policy

In the sub-paragraph on tax policy, major changes proposed to be introduced in direct and indirect taxes in the ensuing financial year will be presented. It shall contain an assessment of income tax exemption limits and how far it relates to per capita income, principles regarding tax exemptions and target group for exemptions.

(2) Expenditure Policy

Under expenditure policy, major changes proposed in the allocation of expenditure shall be indicated. It shall also contain an assessment of principles regarding the benefits and target group of beneficiaries.

(3) Government Borrowings Lending and Investments.

In this sub-paragraph on Government borrowings, the policy relating to internal debt, external debt, Government lending, investments and other activities; including principles regarding average maturity structure, bunching of repayments, etc., shall be indicated.

(4) Contingent and other Liabilities.

Any change in the policy on contingent and other liabilities and in particular guarantees which have potential budgetary implications shall be indicated.

(5) Pricing of Administered Goods.

Any change proposed in the pricing of administered products, including the progress towards market-based principles shall be spelt out.]

C: Strategic priorities for the ensuing year:

(1) [Resource mobilisation for the ensuing financial year through tax, non-tax and other receipts shall be spelt out.

(2) The broad principles underlying the expenditure management during the ensuing year shall be spelt out.

(3) Priorities relating to management of .public debt proposed during the ensuing year shall be indicated.]

D: Rationale for Policy changes

(1) [The rationale for policy changes consistent with the Medium Term Fiscal Policy Statement, in respect of direct and indirect taxes proposed in the ensuing Budget shall be spelt out.

(2) The rationale for major policy changes in respect of budgeted expenditure including expenditure on subsidies shall be indicated.

(3) Rationale for changes, if any, proposed in the management-of the public debt shall be indicated.

(4) The need for changes, if any, proposed in respect of pricing of administered goods shall be spelt out.]

E: Targets for the ensuing year

[At the end of the second quarter, a mid-year assessment shall be made of the trends in receipts and expenditures and achievement of targets of deficit reduction in relation to Budget Estimates. In case the total non debt receipts are less than 40 per cent of Budget Estimates for that year; or the fiscal deficit is higher than 45 per cent of the Budget Estimates for that year; or the revenue deficit is higher than 45 per cent of the Budget Estimates for that year, the Central Government shall take action as required , under sub-sections. (2) and (3) of section 7.]

F: Policy Evaluation:

[This paragraph shall contain an evaluation of the changes proposed in the fiscal policy for the ensuing year with reference to fiscal deficit reduction and objectives set out in the medium term fiscal policy statement.]

Form F - 3 [See rule 4]

MACRO ECONOMIC FRAMEWORK STATEMENT

1. **Overview of the Economy:** [This paragraph shall contain a synoptic analysis of trends in growth rates, prices, output, external sector, money and capital markets. Information on key macro-economic indicators will be presented in the format appended.]

2. **GDP Growth:** [This paragraph shall contain an analysis of trends in overall GDP growth and its sectoral composition.]

3. **External Sector:** [Under this paragraph, trends in exports, imports, foreign exchange reserves, current account balance and balance of payments shall be presented.]

4. **Money, Banking and Capital Markets:** [This paragraph shall present an account of the trends in money supply, bank deposits and credit and developments in the capital market.]

5. **Central Government Finances:** [Under this paragraph an analysis of trends in revenue collections and expenditure shall be presented. Trends in important fiscal deficit and debt indicators shall also be presented. Trends in Central Government finances shall be presented in the format appended.]

6. **Prospects:** [Based on the trends in major sectors presented in the previous sections, an assessment shall be made regarding the growth prospects, along with the underlying assumptions.]

F-3(Contd)
Macro Economic Framework Statement
Economic Performance at a Glance

		Absolute Value		Percentage Changes	
		April-Reporting period*		April-Reporting period*	
		Previous Year	Current Year	Previous Year	Current Year
	Real Sector				
1	GDP at factor cost				
(a)	at current price				
(b)	at 1993-94 price				
2	Index of Industrial Production				
3	Wholesale Price Index (point to point)				
4	Consumer Price Index				
5	Money Supply (M3)				
6	Imports at current prices				
(a)	In Rs. Crore				
(b)	In US $ million				
7	Exports at current prices				
(a)	In Rs. Crore				
(b)	In US $ million				
8	Trade Balance				
9	Foreign Exchange Assets				
(a)	In Rs. Crore				
(b)	In US $ million				
10	Current Account Balance				
	Government Finances				
1	Revenue Receipts				
2	Tax Revenue(Net)				
3	Non-Tax Revenue				
4	Capital Receipts(5+6+7)				
5	Recovery of loans				
6	Other Receipts				
7	Borrowings and other liabilities				
8	Total Receipts(1+4)				
9	Non-Plan Expenditure				
10	Revenue Account Of which:				
11	Interest payments				
12	Capital Account				
13	Plan Expenditure				
14	Revenue Account				
15	Capital Account				
16	Total Expend iture(9+13)				
17	Revenue Expenditure (10+14)				
18	Capital Expenditure (12+15)				
19	Revenue Deficit (17-1)				
20	Fiscal Deficit 16-(1+5+6)				
21	Primary Deficit (20-11)				

*Data will relate to the period up to which information for the current year is available. To facilitate comparison, data. of previous year corresponds to the same period of current year. Accordingly, reporting period may vary for different items.

Form D - 1
[See rule 6]

TAX REVENUES RAISED BUT NOT REALISED

(principal taxes)

(As. at the end of the reporting year)

		Amounts under dispute Rs. crore					**Amounts not under dispute** Rs. crore					
Major Head	Description	Over 1 year but less than two years	Over 2 years but less than 5 years	Over 5 years but less than 10 years	Over 10 years	Total	Over 1 year but less than two years	Over 2 years but less than 5 years	Over 5 years but less than 10 years	Over 10 years	Total	Grand Total
	Taxes on Income & Expenditure											
0020	Corporation Tax											
0021	Taxes on Income other than Corporation tax											
	Taxes on Commodities & Services											
0037	Customs											
0038	Union Excise											
0044	Service Tax											
	TOTAL											

Note: Reporting year refers to the second year preceding the year for which the annual financial statement and demands for grants are’presented.

Form D - 2
[See rule 6]

ARREARS OF NON-TAX REVENUE

(As at the end of the reporting year)

Description	Amounts pending (Rs. crore)				Total
	0-1 years	1-2 years	2-3 years	above 5 years	
Fiscal Services					
Interest receipts Of which From State Governments and Union Territory Governments					
From Railways					
From Departmental Commercial Undertakings					
From Public Sector & other Undertakings					
Dividends and Profit					
General Services					
Police receipts					
Economic Services					
Petroleum Cess/Royalty Communications (License Fee) Receipts					
Other Receipts					
Total					

Note : Reporting year refers to the second year preceding the year for which theannual financial statement and demands for grants are presented.

Form D-3
[See rule 6]

Guarantees given by the Government

Class (No. of Guarantees Within bracket)	Maximum Amount Guaranteed during the year (Rs. crore)	Outstanding at the beginning of the year (Rs.crore)	Additions during the year during (Rs. crore)	Deletions (other than invoked) the year (Rs. crore)
1	2	3	4	5

Invoked during the year Rs. crore		Outstanding at the end of the year (Rs. crore)	Guarantee Commission or Fee (Rs. crore)		Other Material Details
Discharged	Not discharged		Receivable	Received	
6	7	8	9	10	11

Note: The year in the above table refers to the second year preceding the year for which the annual financial statement and demands for grants,are presented.

From D-4
[See rule 6]

ASSET REGISTER

	Assets at the beginning of the reporting year	Assets acquired during the reporting year	Cumulative total of assets at the end of the reporting year
	Cost (Rs.cr)	Cost (Rs. cr)	Cost (Rs.cr)
Physical assets:			
Land			
Building			
Office			
Residential			
Roads			
Bridges			
Irrigation Projects			
Power projects			
Other capital projects			
Machinery & Equipment			
Office Equipment			
Vehicles			
Total			
Financial assets			
Equity Investment			
Shares			
Bonus shares			
Loans and advances			
Loans to State & UT Govts			
Loans to Foreign Govts			
Loans to companies			
Loans to others			
Other financial investments			
Total			

Notes:

1. Assets above the threshold value of Rupees two lakh only to be recorded.
2. This disclosure statement does not include assets of Cabinet Secretariat, Central Police Organisations, Ministry of Defence, Departments of Space and Atomic Energy.
3. Reporting year refers to the second year preceding the year for which the annual financial statement and demands for grants are presented.

F No. 7(3)-B(D)/2003
M. PRASAD, Jt. Secy.

Appendix D

The Constitution (88th amendment) Act, 2003

As passed by the Lok Sabha on 6 May, 2003:[1]

सत्यमेव जयते

THE CONSTITUTION(EIGHTY-EIGHTH AMENDMENT) ACT, 2003
(15th January, 2004.)

An Act further to amend the Constitution of India.

BE it enacted by Parliament in the Fifty-fourth Year of the Republic of India as follows:–

1. (1) This Act may be called the Constitution (Eighty-eighth Amendment) Act, 2003.

   (2) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint.

2. After article 268 of the Constitution, the following article shall be inserted, namely:-

   “268A. (1) Taxes on services shall be levied by the Government of India and such tax shall be collected and appropriated by the Government of India and the States in the manner provided in clause (2).

[1] See http://indiacode.nic.in/coiweb/amend/amend88.htm

(2) The proceeds in any financial year of any such tax levied in accordance with the provisions of clause (1) shall be –

(a) collected by the Government of India and the States;

(b) appropriated by the Government of India and the States,

in accordance with such principles of collection and appropriation as may be formulated by Parliament by law.”.

3. In article 270 of the Constitution, in clause (1), for the words and figures “articles 268 and 269”, the words, figures and letter “articles 268, 268A and 269” shall be substituted.

4. In the Seventh Schedule to the Constitution, in **List I – Union List**, after entry 92B, the following entry shall be inserted, namely:–

“92C. Taxes on services.”.

T. K. VISWANATHAN,

Secy. to the Govt. of India.

Appendix E

Terms of reference of the task force

Ministry of Finance

Creation of a Task Force for implementation of the
Fiscal Responsibility and Budget Management Act, 2003

Parliament passed the Fiscal Responsibility and Budget Management Act (FRBM), to establish a broad framework for the conduct of fiscal policy by setting a medium term target to guide fiscal policy formulation. The framework places an increased emphasis on transparency in budget formulation, implementation and assessment. The FRBM requires the Central Government to eliminate the revenue deficit of around 3.6 per cent of GDP by March, 2008. Towards this, the Central government needs to fix annual targets indicating the path of adjustments and required policy measures.

In view of the above, I hereby constitute a Task Force under the chairmanship of Dr. Vijay Kelkar. Other members of this Task Force will include:

1. Shri D. C. Gupta, Finance Secretary
2. Smt. Vineeta Rai, Revenue Secretary
3. Shri N. S. Sisodia, Secretary (FS)
4. Shri D. Swarup, OSD (Expenditure)
5. Dr. Ashok Lahiri, CEA

Shri M. Prasad, Joint Secretary would be the Convenor.

The Task Force will draw up the medium term framework for fiscal policies to achieve the FRBM objective. It will also formulate the annual targets indicating the path of adjustment and required policy measures.

The Task Force will submit its report by 30th April, 2004.

(Jaswant Singh)
Minister of Finance
18.2.2004

Appendix F

Glossary

Expansions of acronyms are in italics, and terms in boldface are present in the glossary.

Buoyancy The percentage change in tax collections associated with a one percent change in the tax base. For example, if excise collections go up by 0.5 per cent for a 1 per cent increase in manufacturing GDP, the 'buoyancy of excise collections' is said to be 0.5.

Central GST *Central goods and services tax*. This is the term used in this report for the proposed central levy on goods and services along the **VAT** principle. It is proposed that the Central GST would replace the existing **CENVAT** and the existing Service tax. See Section 5.3.

CENVAT *Central VAT*. This is a modified **VAT** levied by the central government upto the manufacturing level. The bulk of what is commonly termed 'excise collections' in India now takes place under the framework of the CENVAT.

CMIE *Centre for Monitoring Indian Economy* (http://www.cmie.com).

EEE *Exempt-Exempt-Exempt*. A framework for tax treatment of savings and investment where contributions, accumulations and benefits (withdrawals) are all tax-exempt. See Section 5.5.4.

EET *Exempt-Exempt-Taxed*. A framework for tax treatment of savings and investment where contributions are exempt, accumulations are exempt, but benefits are taxed as ordinary income. See Section 5.5.4.

FRBM Act *Fiscal Responsibility and Budgetary Management Act*, 2003. See Section 2.6 and Appendix C.

IGST Act *Indian Goods and Services Act*. This is the proposed name for the new legislation which will give legal foundations to the Central-**GST**.

NHAI *National Highway Authority of India* (http://www.nhai.org).

NHDP *National Highway Development Program*, being executed by **NHAI**.

NSDL *National Securities Depository Limited* (http://www.nsdl.co.in).

OLTAS The *Online Tax Accounting System*, which became functional from 1 June 2004. See Section 5.7.1.

RIN The proposed *Risk Intelligence Network* for integrated risk-based assessment of firms, which combines monitoring of **GST** and income tax. See Section 5.7.4.

TIN *Tax Information Network*, the new system for handling tax deducted at source (TDS), and other third party information, that has been built by **NSDL** for the Income Tax Department. See Section 5.7.1.

VAT *Value added tax*. In India, this has become a generic term for a consumption tax collected at all points of exchange of goods and services. This principle is used in the present **CENVAT**, the State VAT and the proposed **GST**.