



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

16 July 2004

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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.

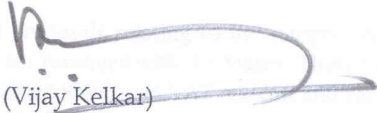
Our proposals on expenditure reforms are essentially in the nature of a policy approach, and would require further discussion with the Planning Commission, administrative Ministries and other stakeholders, to work out a shared program for expenditure reforms.

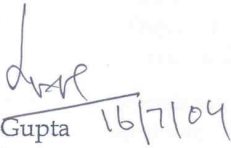
Chapter 6 gives the details of the revenue and expenditure projections. Annexures A and B provide the "empirics" of the revenue projections. Annexure A gives estimates for the various parameters used in the revenue projections. Annexure B gives estimates for revenues from the integration of goods and 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.

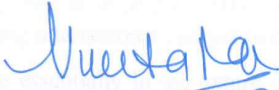
Chapter 7 discusses the economic impact of achieving FRBM targets - i.e. how meeting FRBM objectives through systematic modernisation of taxation and expenditure would give a very positive impulse to the economy in terms of promoting growth, employment, equity and development indicators such as health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

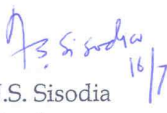
In preparing this report, we should acknowledge the outstanding contribution by Shri Arbind Modi, IRS (IT), Dr. Ajay Shah, Consultant, Shri Gautam Ray, JS (TRU), Shri Jayant Sinha, DS (Budget) and Shri V. S. Chauhan, DS (Budget). Without their dedication, diligence and commitment to the goals of FRBM, 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.

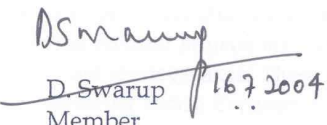
The proposed reforms are indeed bold reforms, and we believe that these reforms, accompanied by other structural reforms, will take our economy on a path of sustained “high quality growth”.

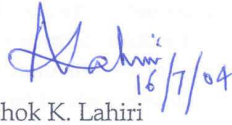

 (Vijay Kelkar)
 Chairman


 D.C. Gupta
 Member
 16/7/04


 Vineeta Rai
 Member
 16/7/2004


 N.S. Sisodia
 Member
 16/7


 D. Swarup
 Member
 16.7.2004


 Ashok K. Lahiri
 Member
 16/7/04

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 than 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 passengers, 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 continue 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 categories 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.

