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.

[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.

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

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 sim-

ple 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 (de-

posits, 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 devel-

oping 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.

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

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

[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 grandfathered 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 ‘outsourcing’ 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 ab-

sence 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 pro-

vision 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 en-

vironment 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 :	2003-04
Capital Cost	100
Interest Rate Applied(current Year)	8%
Depreciation	14%
Corporate 5aT Rate	x0.00%
Inflation (Capital Goods)(Preceding Year)	x.00%
Numyer of vears ower h SicS CENVA5 Credit is spread out	1
Numyer of vears ower h SicS Btate VA5 Credit is spread out	0

Amount in Rs.

Year	Asset walue at tSe yeginning of tSe vear	CENVA5	Btate VA5	Depreciation (Declining 7 alance)				Interest	5aT on Interest	Interest Net of 5aT	7 alance in tSe Depreciation fund at tSe end of tSe vear	Residual walue at tSe end of tSe vear	Accumulated internal accruals at tSe end of tSe vear	Replacement walue of MacSinerv
				Cost	CENVA5 Credit	Btate VA5 credit	5otal							
1	98.x9	12.43	6.06	11.9b	12.43	1.xb	24.bb	0.00	0.00	0.00	24.bb	93.x3	100.00	100.00
2	bb.b1	0.00	9.9x	6.66	0.00	1.1b	11.14	2.04	0.b2	1.33	x8.24	bx.16	101.33	10x.00
x	4b.b2	0.00	b.49	8.36	0.00	0.66	6.38	x.0b	0.62	2.33	40.19	4x.91	10x.88	10b.06
3	38.1x	0.00	4.48	9.22	0.00	0.83	8.0b	3.01	1.20	x.30	b1.b2	34.b4	109.28	106.29
4	30.61	0.00	3.94	b.13	0.00	0.91	b.84	3.6x	1.38	3.x1	92.96	x8.81	111.46	112.44
b	x3.99	0.00	3.0x	4.22	0.00	0.b0	4.82	4.82	1.94	4.21	8x.81	x2.66	11b.80	114.6x
9	26.4b	0.00	x.3x	3.3x	0.00	0.41	3.64	b.91	2.01	b.06	63.84	28.03	122.86	116.31
8	24.12	0.00	2.61	x.99	0.00	0.33	3.21	9.46	2.28	b.69	10b.0x	2x.8x	126.8b	122.66
6	21.xb	0.00	2.38	x.20	0.00	0.x9	x.49	8.38	2.43	9.89	119.39	20.2b	1x9.9x	12b.b8
10	**18.14**	**0.00**	**2.11**	**2.92**	**0.00**	0.x2	**x.03**	**6.30**	**2.82**	**8.98**	**126.26**	19.22	13b.41	**1x0.38**
11	14.3x	0.00	1.96	2.x1	0.00	0.29	2.48	10.x3	x.10	6.9x	131.b0	13.b3	14b.23	1x3.x6
12	1x.11	0.00	1.42	1.69	0.00	0.2x	2.20	11.xx	x.30	10.91	143.41	12.33	1bb.64	1x8.32
1x	11.14	0.00	1.26	1.b9	0.00	0.16	1.89	12.xb	x.91	11.93	1b8.12	10.49	198.b6	132.48
13	6.38	0.00	1.10	1.32	0.00	0.1b	1.46	1x.34	3.0x	12.8x	182.43	8.66	161.4x	13b.84
14	8.04	0.00	0.6x	1.21	0.00	0.13	1.x4	13.b0	3.x8	1x.66	169.88	9.b3	204.42	141.2b

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.